89-593

No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1989

LIBERTY MUTUAL INSURANCE COMPANY and
LIBERTY MUTUAL FIRE INSURANCE COMPANY,

Petitioners,

v.

COMMISSIONER OF REVENUE,
COMMONWEALTH OF MASSACHUSETTS,

Respondent.

On Petition For Writ Of Certiorari
To The Supreme Judicial Court Of Massachusetts

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Massachusetts insurance company gross investment income tax passes muster as a "franchise tax" within the meaning of (former) 31 U.S.C. § 742, and so may be imposed on the interest from United States Government bonds, contrary to the governing decisions of this Court.

2. Whether the Contracts Clause permits a state Commissioner of Revenue to administer state statutes so as to tax bonds issued by independent state authorities, even though the state Legislature and the Commissioner of Revenue's predecessor have declared those bonds to be exempt.

RULE 28.1 STATEMENT

Liberty Mutual Insurance Company and Liberty Mutual Fire Insurance Company (the two Petitioners in this case) are mutual insurance companies incorporated under Massachusetts law. Neither company has any parent or other shareholders. Both companies are owned entirely by their policyholders.

A related mutual insurance company, Liberty Mutual (Bermuda) Ltd., is not a party to this case. It, too, has no shareholders; it is owned by its insured customers. Various subsidiary corporations are owned 100% (except for directors' qualifying shares) by one of the two Petitioners or by the two Petitioners collectively. Those 100%-owned subsidiaries are not included in this statement.

The other entities related to or affiliated with the Petitioners are as follows:

Stein Roe & Farnham, Inc.

Stein Roe International Growth Fund

Liberty All-Star Equity Fund

Liberty Financial Services, Inc.

Liberty Mutual U.S. Government Guaranteed Securities Income Trust

Liberty Mutual Tax-exempt Income Trust

St. James Village, Ltd. (Bermuda)

Spear Financial Services, Inc.

Except as noted, all of the above entities are U.S. domestic corporations.

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PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the Supreme Judicial Court of Massachusetts has been reported at 405 Mass. 352 and is attached to this Petition as Appendix A. It affirmed the opinion of the Massachusetts Appellate Tax Board, which is attached to this Petition as Appendix B. Both the Supreme Judicial Court and the Appellate Tax Board relied heavily on an earlier opinion of the Supreme Judicial Court, *Commissioner of Revenue v. Massachusetts Mutual Life Ins. Co.*, 384 Mass. 607 (1981), which is attached to this Petition as Appendix C.

JURISDICTION

The judgment of the Supreme Judicial Court of Massachusetts was entered on July 11, 1989. *See* Appendix D. This Court's jurisdiction is invoked under 28 U.S.C. § 1257.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

During all of the years in question, Rev. Stat. § 3701, then codified as 31 U.S.C. § 742, provided as follows:

> Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

This statute is now codified at 31 U.S.C. § 3124(a), with minor amendments not relevant to this Petition. Petitioners will continue to refer to the statute as 31 U.S.C. § 742.

Petitioners challenge one branch of the insurance company tax of Massachusetts, which provides in relevant part as follows:

> Every domestic insurance company . . . shall annually pay, as part of its excise imposed under this chapter, an amount equal to *one percent of its total gross investment income* earned during the preceding calendar year, as reported in its annual statement for said year. . . .

Mass. G.L. c. 63, § 22A (emphasis added). Petitioners will refer to this branch of the Massachusetts insurance company tax as Section 22A.

The United States Constitution, Article I, § 8, cl.2, provides that Congress has power "to borrow money on the credit of the United States."

The United States Constitution, Article I, § 10, provides in relevant part that:

> No State shall . . . pass any . . . Law impairing the Obligation of Contracts.

The United States Constitution, Article VI, cl.2, provides in relevant part that:

> This Constitution, and the laws of the United States which shall be made in pursuance thereof . . . shall be the supreme law of the land. . . .

STATEMENT OF THE CASE

Both the Constitution of the United States and a clear federal statute forbid state income taxes on the interest from federal bonds. Massachusetts statutes similarly guarantee that the income from Massachusetts state bonds will be immune from taxation by the Commonwealth. Seeking to avoid these limitations on its authority to tax, the Commonwealth of Massachusetts has denominated a tax on the interest from federal and state bonds, not as an income tax, but as a "franchise" tax. The principal question presented by this case is whether Massachusetts or any other state can evade the protections guaranteed by federal law by the self-serving and arbitrary characterization of a tax as a "franchise" rather than as a property or an income tax.

First, Massachusetts has violated the Borrowing Clause and the Supremacy Clause of the United States Constitution by purporting to include in Section 22A the income from United States Government bonds. Section 22A, adopted in 1971, is an extraordinary tax, measured

by gross investment income without any allowance or deduction for expenses or losses, which Massachusetts imposes only on domestic insurance companies. Under the constitutional rule codified by Congress in 31 U.S.C. § 742, United States Government bonds may not be included in the measure of a state tax, either directly or indirectly, except by way of "nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations."[1]

The exception, as this Court has recognized, must be construed in a way that prevents it from swallowing the rule. Petitioners maintain that Section 22A is not a "franchise tax" within the meaning of 31 U.S.C. § 742, because a franchise tax is imposed on the value of the franchise, and gross income does not fairly measure the value of a franchise. This Court so held in *Northwestern Mutual Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927). Thus, if the statutory term "franchise tax" is anything more than an arbitrary label, 31 U.S.C. § 742 prohibits Massachusetts from taxing the interest on United States Government bonds under Section 22A. Petitioners maintain that Section 22A, either in its entirety or as applied to interest on United States Government bonds, should be struck down for violation of the Supremacy Clause and 31 U.S.C. § 742.

Second, the Massachusetts Commissioner of Revenue has violated the Contracts Clause of the United States Constitution by purporting to include in Section 22A the income from state bonds that have been declared exempt by the Massachusetts Legislature. The Massachusetts Legislature has created several independent Authorities by special enabling acts. The Legislature induced insurance companies and other investors to purchase bonds of

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[1] The statute also includes exceptions for estate and inheritance taxes which are not relevant here.

these Authorities by providing in the enabling acts that their bonds would be exempt from Massachusetts taxation. In 1958 the State Tax Commission of Massachusetts ruled that Authority bond interest is exempt from the corporate excise tax by virtue of the enabling acts. Petitioners maintain that the Contracts Clause bars the Commissioner of Revenue from now including such Authority bond interest in income taxable under Section 22A. Accordingly, Section 22A should be applied so as to exclude Authority bond interest. When so applied Section 22A becomes discriminatory in violation of 31 U.S.C. § 742, since it taxes federal obligations but not state obligations, and therefore, either in its entirety or as applied to interest on United States Government bonds, should be struck down.

This Petition concerns tax years 1971 through 1977. During these years, Petitioners received income from United States Government bonds and from bonds of the Massachusetts Bay Transportation Authority ("MBTA"), the University of Massachusetts Building Authority ("UMBA") and the Massachusetts Housing Finance Agency ("MHFA"). Pursuant to Section 22A, Petitioners paid for each of these years a Massachusetts tax which included one percent of the income from each of these federal and state bonds. Petitioners subsequently filed claims for refunds of the entire tax paid under Section 22A, which the Commissioner of Revenue denied. Petitioners challenged this denial before the Appellate Tax Board, and that body upheld the Commissioner's action. The Supreme Judicial Court of Massachusetts affirmed. Petitioners stated both of the questions presented here in their written claims for refunds, in their petitions to the Appellate Tax Board, and in their appeal to the Supreme Judicial Court.

REASONS FOR GRANTING THE WRIT

This case presents in clear form constitutional issues of great current significance. Taxation of bond interest is

a major source of revenue for many states. In recent years many states have strained to raise revenues by taxing United States Government bonds and state bonds that had previously been exempt. These measures substantially increase the cost of federal funds to the United States Government,[2] and raise recurring and important issues of federal supremacy and the impairment of contracts. This Petition presents a good opportunity for the Court to clarify conflicting decisions, to correct states which have taken advantage of this Court's relative inattention, and to provide guidance to both the states and taxpayers as to how interest on federal and state bonds may and may not be taxed.

Under 31 U.S.C. § 742, the interest on federal bonds is exempt from state taxes except in the case of "nondiscriminatory or other non-property taxes in lieu thereof." The Supreme Judicial Court held that Section 22A is such a permitted tax. A5. The Supreme Judicial Court baldly and incorrectly asserted that this Court's decision in *Northwestern Mutual Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927), is no longer sound law. A6-7. This Court has never overruled or impaired *Northwestern Mutual*, however, and *Northwestern Mutual* has been cited as recently as 1981 by the court of last resort in another state. *See Continental Bank v. Arizona Department of Revenue*, 638 P.2d 228, 234 (Ariz. 1981).

The Supreme Judicial Court also held that Authority bond interest may be included in the measure of income subject to tax under Section 22A, despite the explicit statutory provision for tax exemption contained in the enabling acts of the Authorities. The Supreme Judicial Court held that this exemption applies only to a direct tax

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[2] In 1988 the net interest paid by the United States Treasury on public debt was $151.711 billion. Federal Reserve Bulletin, June 1989, at A29. If the Treasury were forced to raise the interest rate by 1.01% in order to counterbalance a one percent tax imposed by state statutes such as Section 22A, the cost to the United States would be $1.532 billion per year.

on income, and not to an excise tax. A8-9. This judicial sleight of hand is impermissible under *Macallen Company v. Massachusetts*, 279 U.S. 620 (1929), and is contrary to decisions by courts of last resort in other states.

I. Whether A State Gross Income Tax May Be Sustained As A "Franchise Tax" – Notwithstanding This Court's Clear Opinion To The Contrary In Northwestern Mutual – Is An Important Question Of Federal Law, Because The Meaning Of This Statutory Term Has Confused State Courts and Requires Clarification.

This case presents the important question, which has given rise to confusion in the state courts, whether a state may evade the constitutional and statutory prohibitions against the taxation of income from federal bonds merely by designating its exaction as a "franchise tax." Section 22A purports to include interest from federal bonds in the measure of taxable gross investment income. It may not validly do so, however, unless it is a "franchise tax" permitted under 31 U.S.C. § 742. Despite its label, Section 22A is not a franchise tax, since it imposes a direct tax on a class of income, and since it does not fairly measure the value of the franchise.

This case presents in unusually clear form the important question of what Congress meant when it used the term "franchise tax" in 31 U.S.C. § 742. This Court treated 31 U.S.C. § 742 in three opinions approximately five years ago. *See First National Bank of Atlanta v. Bartow County Board of Tax Assessors*, 470 U.S. 583 (1985); *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983); *Memphis Bank & Trust Company v. Garner*, 459 U.S. 392 (1983). Those opinions have given rise to a flurry of litigation in state courts challenging various state taxes which include federal bonds. *First National Bank of Atlanta, American Bank* and *Memphis Bank* left open the question of what constitutes a "franchise tax" permitted by the federal statute. *See* Blasi and Joyce, *The Franchise Tax Exception To The Federal Exemption Statute*, 102 Banking L.J. 462 (1985) ("the

Supreme Court has failed to provide the drafters of state laws with a workable definition of a franchise tax").

A. That the interest on federal bonds may not be taxed is a fundamental principle of federal constitutional, statutory, and decisional law that deserves this Court's attention and protection. Review of this case is needed to achieve the legislative purposes of the 1959 amendment to 31 U.S.C. Section 742.

Ever since *McCulloch v. Maryland*, 4 Wheat 316 (1819), this Court has held that the states may not burden the federal government's exercise of its powers. Consistent with this core principle of American federalism, the states may not impose a tax on United States Government bonds, because this would burden the federal government's exercise of its power to borrow money. *See Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829). Congress codified this fundamental principle of federal immunity in 1862, providing that "obligations of the United States . . . shall be exempt from taxation by or under state or municipal or local authority." Act of February 25, 1862, Chapter 33, Section 2, 12 Stat. 346. The governing statute, 31 U.S.C. § 742, read in that form until 1959.

Over the course of the century after the statute was enacted, there developed a judicial exception to this statutory prohibition. The courts held that interest on federal bonds could be included in the measure of a permissible franchise or privilege tax, so long as the tax was imposed on the privilege of doing business, and not on the bond income itself. This judicial exception rested on a distinction between a tax "on" bond income and a tax "measured by" bond income, a distinction recently characterized by this Court as "formalistic". *American Bank*, 463 U.S. at 862, 866-67.

This formalistic distinction created a severe and obvious risk that the fundamental immunity principle would be evaded. Congress amended the statute in 1959

to eliminate "formalistic" distinctions. *American Bank*, 463 U.S. at 866-67.[3] The amendment was prompted by a tax imposed by Idaho. Idaho included federal bond interest in income subject to the state's personal income tax, maintaining that the tax was not a direct tax "on" income, but rather a tax on individuals which was merely "measured by" income. Congress responded to the Idaho tax by adding the second sentence of the current statute:

> This exemption extends to *every form* of taxation that would require that either the obligations *or the interest* thereon, or both, be considered, *directly or indirectly*, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes (emphasis added).

Congress acted to protect the U.S. Treasury from any state taxes, however labelled, that increase the cost of issuing bonds. *See State Taxation of Bank Shares: American Bank & Trust Co. v. Dallas County*, 1984 Annual Review of Banking Law 391, 398. Congress made clear that Idaho may not include United States Government bond interest in Idaho's personal income tax simply by labelling it a tax on individuals. Similarly, Massachusetts cannot include United States Government bond interest in Section 22A simply by labelling it a tax on the privilege of doing business. Section 22A cannot include federal bond interest unless it is truly a legitimate franchise tax.[4]

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[3] The statute was amended again in 1982 by omitting surplus words, but this amendment was not intended to make any substantive change. *American Bank*, 463 U.S. at 859 n.1.

[4] Recent decisions of this Court treating other branches of the doctrine of intergovernmental immunity suggest that the doctrine focuses almost entirely on discrimination. *See Davis v. Michigan Department of Treasury*, 103 L. Ed. 2d 891 (1989); *South Carolina v. Baker*, 108 S. Ct. 1355 (1988). *But see Society For Savings v. Bowers*, 349 U.S. 143, 144 (1955). Section 742 as

(Continued on following page)

The language of the current statute contains a paradox, however, which badly needs judicial clarification. The judicially created category of "franchise taxes," as understood prior to 1959, rests on the formalistic distinction between a tax "on" income and a tax "measured by" income. As understood prior to 1959, an income tax was a tax imposed "on" income, whereas a franchise tax was a tax imposed "on" the privilege of doing business and merely "measured by" income. In 1959 Congress acted to eliminate this distinction (at least with respect to taxes on individuals), and yet the statutory exemption for franchise taxes may rest in part on the same distinction. *See* Blasi and Joyce, *Bank Shares Taxation, Another Trap For the Unwary Draftsman*, 51 Tenn. L. Rev. 445, 446-47 (1984). Petitioners' case exposes this paradox and presents an excellent opportunity for this Court to eliminate the confusion.

This Court's most important response to the risk created by formalistic distinctions in this area came in *Northwestern Mutual Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927), which ruled that a state may *not* include United States Government bonds in the measure of a gross income tax such as Section 22A. It is well established that the 1959 amendment to 31 U.S.C. § 742 was intended to codify existing case law and to broaden the prohibition contained in the statute, not to narrow it. *First National Bank of Atlanta*, 470 U.S. at 594; *American Bank*, 463 U.S. at 863-65. Accordingly, the tax that was struck down in *Northwestern Mutual* is still forbidden today.

In *Northwestern Mutual* Wisconsin imposed on insurance companies an annual license fee of three percent of

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enacted in 1959 prevents more than discrimination, however. In order to tax federal bonds a state tax must not only be nondiscriminatory, it must also be a franchise tax. It is well established that Congress has the power to "enlarge it [immunity] beyond the point where, Congress being silent, the Court would set its limits." *Helvering v. Gerhardt*, 304 U.S. 405, 411-12 n.1 (1938).

gross non-premium income. Wisconsin argued that this tax was imposed on the privilege of doing business, not on the income itself, and could therefore include federal bond interest. This Court squarely rejected Wisconsin's argument.

> The fundamental question . . . is whether by the true construction of the statute the assessment must be regarded as a tax upon property or one on privileges or franchise of the corporation. . . .
>
> The distinction between an imposition the amount of which depends upon dividends or net receipts and one measured by gross returns is clear. *U.S. Glue Co. v. Town of Oak Creek,* 247 U.S. 321, 328, and earlier opinions there cited. . . .
>
> Here the statute undertook to impose a charge of 3 percent upon every dollar of interest received by the Company from United States bonds. So much, in any event, the State took from these very receipts. This amounts, we think, to an imposition upon the bonds themselves and goes beyond the power of the State.

275 U.S. at 140-41. *Northwestern Mutual* squarely held that a tax measured by gross income is not a franchise tax. It expressly distinguished taxes measured by net income. *See Orange Mutual Life Co. v. State Tax Commission,* 283 P.2d 187, 193 (Idaho 1955) (affirming distinction between tax measured by gross income and tax measured by net income).

Despite the contrary suggestions of the Supreme Judicial Court, the rationale of *Northwestern Mutual* remains sound. If the integrity of the statutory and constitutional tax immunities is to be upheld, protective lines must be drawn. The line drawn by *Northwestern Mutual* – and rejected by the Massachusetts court in this case – is plain. The three percent gross income tax imposed by Wisconsin, like the gross income tax imposed by Section 22A, made no attempt to measure fairly the value of the privilege of doing business. It did not take into account

any factor other than the receipts themselves. The inference was therefore unmistakable, especially in light of the constitutional imperative to protect the integrity of federal tax immunity, that a gross income tax levied on the income from United States bonds is in substance, purpose and effect a tax on the bonds themselves. Whether or not a franchise tax might reasonably be levied on *net* income, a *gross* income tax, whatever label the state might attempt to apply, must be invalidated as an unlawful burden on the federal power to borrow money.[5]

The Supreme Judicial Court of Massachusetts erroneously pronounced that *Northwestern Mutual* has been overruled. A6-7, *citing, Werner Machine Co. v. Director of Division of Taxation*, 350 U.S. 492 (1956). In fact, however, *Werner Machine Co.* concerned a tax measured by *net worth*, one of the traditional measures of a franchise tax. This Court has never endorsed a franchise tax measured by *gross* income, and this Court has never questioned, let alone overruled, *Northwestern Mutual. Cf. Society for Savings v. Bowers*, 349 U.S. 143 (1955) (striking down property tax); *Tradesmens National Bank of Oklahoma v. Oklahoma Tax Comm'r*, 309 U.S. 560 (1940) (upholding tax measured by *net* income); *Educations Films Corp. v. Ward*, 282 U.S. 379 (1931) (upholding tax measured by *net* income); *Des Moines National Bank v. Fairweather*, 263 U.S. 103 (1923)

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[5] As the Court stated in *U.S. Glue Co. v. Town of Oak Creek*, 247 U.S. 321 (1918): "The difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction. . . . A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss. . . . A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large. . . ." 247 U.S. at 328-29.

(upholding tax measured solely by capital stock); *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911) (upholding tax measured by *net* income); *Home Ins. Co. v. New York*, 134 U.S. 594 (1890) (upholding tax measured by capital stock and dividends); *Provident Institution v. Massachusetts*, 73 U.S. (6 Wall.) (1868) (upholding tax measured by value of assets).

The court of last resort in another state has cited *Northwestern Mutual* as recently as 1981. *See Continental Bank v. Arizona Department of Revenue*, 638 P.2d 228, 234 (Ariz. 1981). The courts of last resort in two other states have suggested that *Northwestern Mutual* has been overruled. *See Midland Financial Corp. v. Wisconsin Department of Revenue*, 341 N.W.2d 397, 405 & n.10 (Wis. 1983) (suggesting that *Northwestern Mutual* was overruled by the amendment of 31 U.S.C. § 742 in 1959); *Anderson-Cherne v. Commissioner of Taxation*, 226 N.W.2d 611, 614 (Minn. 1975) (suggesting that *Northwestern Mutual* was overruled by *Werner Machine Co.*). Taxpayers, state legislatures and state tax departments would benefit from a clarification of the status of *Northwestern Mutual*, which only this Court can provide.

Not only did this Court rule in *Northwestern Mutual* that a gross income tax is not a franchise tax, but in fact a gross income tax does not fit the accepted meaning of the term. In ordinary usage the term "franchise tax" means a tax which measures the *value* of the privilege of doing business in corporate form. A franchise tax is:

> A tax on the franchise of a corporation, that is, on the right and privilege of carrying on business in the character of a corporation, for the purposes for which it was created, and in the conditions which surround it.

Black's Law Dictionary 593 (5th ed. 1979); *Home Ins. Co. v. New York*, 134 U.S. 594 (1890). This Court described franchise taxes further in *American Bank*. As the Court observed:

> [F]ranchise and estate and inheritance taxes customarily assess the franchise or the demise at

> the value of the assets of the business or at the value of the property inherited. *See, e.g., Werner Machine Co. v. Director of Taxation*, 350 U.S., at 492 (franchise tax measured by "net worth"); . . . *Home Ins. Co. v. New York*, 134 U.S., at 599 (franchise tax measured by "capital stock and dividends").

463 U.S. at 863. Section 22A does not employ any of the accepted methods. Section 22A does not assess an insurance company's franchise at the value of its assets, nor does Section 22A measure the insurance company's net worth or the value of its capital stock. Section 22A imposes a tax measured solely by gross income. But gross income, calculated without any deductions for debts or expenses, cannot measure the *value* of a franchise. In fact, a Massachusetts insurance company could be losing money or could be insolvent, and yet it would still be assessed a tax under Section 22A. Thus Section 22A does not fairly measure the value of the franchise, and Section 22A does not fall within any accepted meaning of the term "franchise tax."

B. Review of this case is needed to assure coherence and consistency in the application of 31 U.S.C. Section 742.

In upholding Section 22A as a permissible franchise tax, the Massachusetts Supreme Judicial Court refused to acknowledge the controlling authority of this Court's decision in *Northwestern Mutual*. Moreover, it so construed the applicable federal statute as to create a loophole of gargantuan proportions. According to its reasoning, a state's selection of the label "franchise tax" would exert a talismanic force in defeating the tax immunities conferred by the federal constitution and by federal statute. If the "franchise tax" exception is to be an analytical category rather than an endlessly expansive loophole, Section 22A must be invalidated on grounds of its incompatibility with the Constitution and laws of the United States.

The Supreme Judicial Court's refusal to be bound by this Court's decision in *Northwestern Mutual* would itself merit review by this Court. The necessity of review is made even more urgent by a recurring pattern of confusion regarding the construction of 31 U.S.C. § 742. The pattern is one in which courts, including this Court, have sometimes exalted form over substance: they have upheld taxes that diminish the value of federal bonds (and thus increase the cost to the United States Treasury) so long as, formalistically, the taxes were denominated as franchise taxes and the amount of the tax was said to be "measured by", rather than "levied on", income from federal bonds.

The formalistic approach to constitutional tax questions, from which the decision below takes its rationale, is one that this Court has recently renounced. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), laid down the clear and sensible rule that real economic effects, not formalistic labels, should govern questions of the states' constitutional authority to impose a tax. *Complete Auto Transit* rejected the notion that a state tax may be valid simply because the state says it is imposed for the privilege of doing business. As the Court stated, "[t]here is no economic consequence that follows necessarily from the use of the particular words, 'privilege of doing business,' and a focus on that formalism merely obscures the question whether the tax produces a forbidden effect." *Complete Auto Transit*, 430 U.S. at 288.

This case presents a much needed opportunity to clarify not only the status of *Northwestern Mutual* as applied to a "franchise tax" measured by gross income, but also the status of *Complete Auto Transit* and *American Bank* as applied to a "franchise tax" measured by income of any kind.[6] *American Bank* extends the focus on real

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[6] The tax at issue in *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), was measured by net earnings. The Court expressly reserved the question whether this tax could be characterized as a franchise tax. *Id.* at 396 n.6. The question is an important and urgent one.

economic effects to questions arising under 31 U.S.C. § 742. As *American Bank* recognized, Congress amended the controlling statute in 1959 in order to eliminate formalistic distinctions. Thus it appears – but apparently has not yet been stated clearly enough by this Court to make the state courts understand that they are bound – that there is no longer any constitutional distinction between a tax "on" bond income and a tax "measured by" bond income. *See American Bank & Trust Co. v. Dallas County: The Quiet Passing of the Separate Incidence Rule*, 41 Tax Lawyer 831 (1988). As this Court held in *American Bank*, a tax purportedly levied on bank shares was "barred, regardless of its *form* if federal obligations must be considered, either directly or indirectly, in computing the tax."

Certain of the courts of last resort in the various states have ignored the teaching of *Complete Auto Transit* and *American Bank* and have used outmoded tax labelling to preserve (but never to strike down) challenged state taxes. *See National Bank of Alaska v. State of Alaska*, 769 P.2d 990 (Alaska 1989) (business license tax measured by percentage of net income is a franchise tax); *Centerre Bank of Crane v. Director of Revenue*, 744 S.W.2d 754 (Mo. 1988) (upholding inclusion of federal bond interest under tax measured by net income); *Savings League of Wisconsin, Ltd. v. Wisconsin Dept. of Revenue*, 416 N.W.2d 650 (1987), *appeal dismissed*, ___ U.S. ___, 109 S. Ct. 37 (1988) (United States Government bonds may be included under Wisconsin's corporate franchise tax, even though this tax is substantively identical to Wisconsin's corporate income tax); *State Department of Assessments and Taxation v. Maryland National Bank*, 531 A.2d 294 (Md. 1987), *appeal dismissed*, ___ U.S. ___, 108 S. Ct. 2812 (1988); *Department of Revenue v. First Union National Bank of Florida*, 513 So.2d 114 (Fla. 1987), *appeal dismissed*, ___ U.S. ___, 108 S. Ct. 1253 (1988); *Garfield Trust Co. v. Director, Division of Taxation*, 508 A.2d 1104 (N.J. 1986), *appeal dismissed*, 479 U.S.

925 (1986); *Reuben L. Anderson-Cherne, Inc. v. Commissioner of Taxation*, 226 N.W.2d 611 (Minn. 1975), *appeal dismissed*, 423 U.S. 886 (1975) (franchise tax may use net income as a yardstick, so long as the tax is imposed only where the earning of income and the exercise of privilege coincide). These decisions assert that any tax which purports by its label to be imposed on the privilege of doing business constitutes a "franchise tax" within the meaning of 32 U.S.C. § 742. They clearly reduce the statutory term to a mere label.[7]

Other state courts have examined the substance and effect of a state tax in order to determine whether the income of tax-exempt bonds may be included. *See First Federal Savings & Loan Ass'n of Philadelphia v. Commonwealth*, 528 A.2d 942 (Pa. 1987) (mutual thrift institution tax was in substance and effect a tax on income, despite label designating it as a tax for the privilege of doing business); *Dale National Bank v. Commissioner*, 465 A.2d 965 (Pa. 1983) (bank shares tax was in substance and effect a property tax, despite the Legislature's attempt to re-label it as a tax on the privilege of doing business); *Federal Prod. Corp. v. Norberg*, 429 A.2d 447 (R.I. 1981) (proceeds of sale of U.S. Government bonds could not be included in the measure of net income subject to business corporation tax). *See also Cambridge State Bank v. Roemer* (District Court, Ramsey County Minnesota) (May 20,

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[7] The fact that the Supreme Court dismissed the taxpayer's appeal from the decisions in four of these net income cases does not mean that this Court approved the reasoning of these decisions. *See Mandel v. Bradley*, 432 U.S. 173 (1977) (summary affirmances affirm only the judgments of lower courts and not their reasoning). Furthermore this Court denied *certiorari* in *First Federal Savings and Loan Assoc. v. Department of Revenue*, 654 P.2d 496 (Mont. 1982), *cert. denied*, 462 U.S. 1144 (1983), which struck down a state tax despite its label. *See infra*, text accompanying footnote 8.

1987) (Minnesota bank tax was a direct tax on income from U.S. Government bonds); *C.C. Collings & Co., Inc. v. Commonwealth*, 488 A.2d 1187 (Cmwlth. Ct. Pa. 1984), *aff'd per curiam sub nom. Commonwealth Securities and Investments, Inc. v. Commonwealth*, 514 A.2d 1373 (Pa. 1986) (corporate net income tax was in substance and effect a tax on income, despite being labelled as tax for the privilege of doing business). These courts focus on the actual economic effect of the tax, as Congress did in 1959 and as this Court instructed in *Complete Auto Transit* and *American Bank*. As these courts correctly reason, "in the last analysis the nature of the tax depends not upon its label but upon . . . its practical operation and effect." *First Federal Savings & Loan Ass'n of Philadelphia v. Commonwealth*, 528 A.2d 942, 945 (Pa. 1987). In other words, *"the issue is not the rationale for exacting the payment, but the subject of the exaction." Id.* at 946 (emphasis in the original).

The court of last resort in one state moved from one side of the conflict to the other in a two-year span. The Supreme Court of Montana ruled in *First Federal Savings & Loan Ass'n v. Department of Revenue*, 654 P.2d 496 (Mont. 1982), *cert. denied*, 462 U.S. 1144 (1983), that Montana's bank tax was an impermissible direct tax on income from federal bonds. While the Montana court subsequently reversed itself in *Schwinden v. Burlington Northern, Inc.*, 691 P.2d 1351 (Mont. 1984), it is clear that the later decision was the result of a desire to maintain revenues.[8] Many state courts have understandably sympathized with this desire, but it is not a permissible basis for abridging the immunity afforded federal bonds by the Constitution, Congress and this Court. The Montana court's easy and political change of labels illustrates the potential for confusion and abuse in this area.

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[8] The *Schwinden* opinion emphasizes the fiscal emergency created by *First Federal*. Further, the decision to reexamine *First Federal* was suggested by the Montana Bankers Association appearing as an *amicus curiae*, not by any of the parties.

Section 742's central prohibition against "direct or indirect" taxes would be rendered a nullity if the states were allowed to include the income from federal bonds in any tax scheme that they denominated as "franchise taxes." Yet that is precisely what the Massachusetts court allowed in this case. The Supreme Judicial Court upheld Section 22A because it characterized Section 22A as a tax not imposed "on" bond income, but merely "measured by" bond income. A6-7. This labelling is contrary to the teaching of *Complete Auto Transit* and *American Bank*, and it flatly conflicts with the approach taken by Pennsylvania in *First Federal Savings & Loan Ass'n of Philadelphia v. Commonwealth*, 528 A.2d 942 (Pa. 1987), *supra*. If Congress did indeed eliminate formalistic distinctions when it amended 31 U.S.C. § 742 in 1959, then the decision of the Supreme Judicial Court cannot stand.

To achieve coherence and enforceability in the administration of 31 U.S.C. § 742, this Court must give guidance to the state courts on the pressing practical question of what types of exactions do and do not qualify as "franchise taxes." In response to this question, the formalistic answer of the Supreme Judicial Court, which refused to go beyond labels to examine real economic effect, was arbitrary and, from the federal perspective, dysfunctional and impermissible. As shown above, gross income cannot measure the value of a franchise. Thus if Section 22A is a "franchise tax" within the meaning of 31 U.S.C. § 742, then any non-property tax is a "franchise" tax, reducing the term "franchise" tax to a mere label of convenience. This labelling threatens to create a loophole in Section 742's tax-exemption scheme at least as large as the one that the Court closed in *American Bank*. Indeed, it creates a loophole that *American Bank* – closing another claimed loophole in the same statute – has given state legislatures new incentive to exploit. The question presented by this case is therefore of great and increasing practical importance.

The steady stream of cases cited above also demonstrates that the meaning of the term "franchise tax"

contained in 31 U.S.C. § 742 is an important issue to taxpayers, legislatures and tax commissioners across the nation. Billions of tax dollars are at issue in these cases – a substantial portion of the tax revenues of the affected states. The courts of many states have increasingly – and not surprisingly – tended to rule in favor of upholding tax revenues.[9] This Court is the only forum available to give full weight to the important federal interests involved in the taxation of United States Government bonds. Thus this Court ought to reach the merits of at least one of the cases in this area. The present case is a particularly appropriate one for review because of its direct presentation of the critical issues, and because of the cavalier way in which the Supreme Judicial Court set aside this Court's decision in *Northwestern Mutual.*

II. Whether A State's Commissioner Of Revenue May Without Constitutional Amendment, Legislation Or Even Regulation Disregard The Ruling Of His Predecessor And Legislation Which Exempts The Bonds Of Independent Authorities Is An Important Question Under The Contracts Clause.

This case also presents an important issue of the impairment of contracts, because the Massachusetts Commissioner of Revenue has attempted to tax the bonds of certain

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[9] Even in several cases where a state court has struck down a tax as unconstitutional under *Memphis Bank* or *American Bank,* the state court nonetheless gave its decision only prospective effect. *See First of McAlester Corporation v. Oklahoma Tax Commission,* 709 P.2d 1026 (Okla. 1985); *First Bank of Deer Park v. Deer Park Independent School District,* 770 S.W.2d 849 (Texas Ct. of Appeals 1989); *Schreiner Bank v. Kerrville Independent School District,* 683 S.W.2d 466 (Texas Ct. of Appeals 1984). *See also McKesson Corp. v. Florida,* 524 So.2d 1000 (Fla. 1988), *cert. granted,* ___ U.S. ___, 109 S. Ct. 389 (Nov. 14, 1988), *restored for reargument,* ___ U. S. ___, 109 S. Ct. 3238 (Jul. 3, 1989); *American Trucking Ass'n, Inc. v. Arkansas Highway and Transp. Dept.,* 746 S.W.2d 377 (Ark. 1988), *cert. granted,* ___ U. S. ___, 109 S.

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independent Authorities, which the Legislature and the State Tax Commission have declared to be exempt. Both before and especially since this Court's decision in *Memphis Bank & Trust Company v. Garner*, 459 U.S. 392 (1983), tax commissioners in many states have attempted to raise tax revenues from tax-exempt state bonds,[10] and taxpayers have challenged these attempts. *See, e.g., Centerre Bank of Crane v. Director of Revenue*, 744 S.W.2d 754 (Mo. 1988) (bonds of Missouri authorities); *First Federal Savings & Loan Ass'n of Philadelphia v. Commonwealth*, 528 A.2d 942 (Pa. 1987) (obligations issued by Pennsylvania, its agencies and political subdivisions); *Department of Revenue v. First Union National Bank of Florida*, 513 So.2d 114 (Fla. 1987), *appeal dismissed*, ___ U.S. ___, 108 S. Ct. 1253 (1988) (Florida water and sewer bonds and Pasco County Expressway bonds); *Garfield Trust Co. v. Director, Division of Taxation*, 508 A.2d 1104 (N.J. 1986), *appeal dismissed*, 479 U.S. 925 (1986) (state, local and authority bonds of New Jersey); *Cambridge State Bank, et al. v. Roemer* (District Court, Ramsey County Minnesota) (May 20, 1987) (bonds of Minnesota agencies); *C.C. Collings & Co., Inc. v. Commonwealth*, 488 A.2d 1187 (Cmwlth. Ct. Pa. 1985), *aff'd per curiam sub nom. Commonwealth Securities and Investments, Inc. v. Commonwealth*, 514 A.2d 1373 (Pa. 1986) (obligations of Pennsylvania, its agencies and political subdivisions).[11] It is an important question whether – and to what extent – the Contracts Clause prohibits such taxation.

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Ct. 389 (Nov. 14, 1988), *restored for reargument*, ___ U.S. ___, 109 S. Ct. 3238 (Jul. 3, 1989); *James B. Beam Distilling v. Georgia* (Supreme Ct. of Georgia No. 46642) (July 14, 1989) (available on Westlaw); *National Can Corp. v. Department of Revenue*, 749 P.2d 1286 (Wash. 1988), *appeal dismissed*, ___ U.S. ___, 108 S. Ct. 2030 (1988).

[10] Under *Memphis Bank*, tax commissioners must include all state bonds in the measure of any franchise tax, or else they will lose the ability to tax federal bonds.

[11] Four of these cases concern bonds of independent authorities. Thus it is clear that the second issue raised by this Petition has immediate significance for many states in addition to Massachusetts.

On two occasions, in cases more than a century old but never overruled or declared incorrect, this Court held that a legislature can enact a contractually binding tax exemption, and that when it does so, a refusal to honor that exemption offends the Contracts Clause. *See Murray v. Charleston*, 96 U.S. 432, 444 (1878); *University v. People*, 99 U.S. 309 (1879). The Court reaffirmed this position in *Macallen Company v. Massachusetts*, 279 U.S. 620 (1929), which found that the Massachusetts Legislature's attempt to tax certain county bonds "impairs the obligation of the statutory contract of the state by which such bonds were made exempt from state taxation." 279 U.S. at 634 (emphasis added). Although the scope of the *Macallen* holding was limited two years later in *Educational Films Corporation v. Ward*, 282 U.S. 379 (1931), its core prohibition remained intact. As *Educational Films* interpreted *Macallen*, *Macallen* rested on a finding that the Massachusetts Legislature had amended the taxing statute with the specific intent to reach bond income it had earlier declared exempt. *See Educational Films*, 282 U.S. at 392.

The application of Section 22A to the tax-exempt bonds of state Authorities fits the paradigm of behavior forbidden by the Contracts Clause as construed in this Court's cases. During the tax periods in question, Petitioners held bonds of three Massachusetts authorities: the MBTA, the UMBA and the MHFA. The enabling Acts of these three Authorities expressly exempt Authority bond interest from Massachusetts taxation:

> Bonds and notes issued by the authority, their transfer and the income therefrom, including any profit made on the sale thereof, shall at all times be free from taxation within the commonwealth.

Mass. G.L. c. 161A, § 18; St. 1964, c. 563, § 18 (MBTA).

> [T]he notes and bonds issued under the provisions of this act, their transfer and the income therefrom, including any profit made on the sale thereof, shall at all times be free from taxation within the commonwealth.

Mass. G.L. c. 75 App., § 1-15; St. 1960, c. 773, § 15 (UMBA).

> The Commonwealth covenants with the Purchasers and all subsequent holders and transferees of the notes and bonds issued by the MHFA, in consideration of the acceptance of any payment for the notes and bonds, that the notes and bonds of the MHFA issued pursuant to this act and the income therefrom shall at all times be free from taxation.

Mass. G.L. c. 23A App., § 1-12; St. 1966, c. 708, § 12 (MHFA).

The three Enabling Acts further demonstrate that in each case the Legislature specifically intended that the tax exemption should apply when the bonds are held by insurance companies. All three statutes provide that bonds of the Authority are securities in which insurance companies may invest. *See* c. 161A, § 25 (MBTA); c. 75 App., § 1-16 (UMBA); and c. 23A App., § 1-13 (MHFA). Moreover in the latter two Enabling Acts the provision making the bonds eligible for investment follows immediately after the provision for tax exemption. Thus the Massachusetts Legislature induced insurance companies and others to buy Authority bonds (and effectively lowered the interest rate the Authorities had to pay on those bonds) by providing that Authority bonds would be exempt from taxation in Massachusetts.

In 1958 a ruling of the Massachusetts State Tax Commission affirmed that Authority bond interest is tax-exempt. Corporation Excise Tax Ruling 1958-7 ("Ruling 1958-7") was signed by all three members of the State Tax Commission, including the then Commissioner of Corporations and Taxation.[12] Ruling 1958-7 specifically dealt

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[12] Until the reorganization of the Department of Revenue in 1978, which eliminated the State Tax Commission and placed a Commissioner in charge of the Department of

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with the then corporate excise tax. (Section 22A did not then exist.) However, its holding rested on the language of the enabling acts, not the language of the tax statute, and thus clearly is applicable to Section 22A. In pertinent part, Ruling 1958-7 provides as follows:

> "Net income" is defined in Chapter 63, section 30(5) as
>
> "the gross income from all sources, without exclusion, for the taxable year, less the deductions, other than losses sustained by the corporation in other fiscal or calendar years and other than dividends, allowable by the federal revenue act applicable for said calendar year. . . ."
>
> 2. Interest on bonds of certain instrumentalities of Massachusetts *where the statute creating the instrumentality exempts interest on its bonds from taxation*, does not form a part of "gross income" under section 30(5) of Chapter 63. Examples of such instrumentalities are Massachusetts Turnpike Authority, Mystic River Bridge Authority, New Bedford, Woods Hole, Martha's Vineyard and Nantucket Steamship Authority, Massachusetts Port Authority, Mount Greylock Tramway Authority, University of Massachusetts.

Ruling 1958-7, [1 Mass.] St. Tax Rep. ¶ 10-320.40 (Aug. 12, 1958) (emphasis supplied).

The enabling acts for the Massachusetts Turnpike Authority and the Massachusetts Port Authority, which are cited as examples in Ruling 1958-7, contain tax-exemption language which is virtually identical to the enabling acts at issue in this case. *See* G.L. c. 81 App., § 1-13 (Massachusetts Turnpike Authority); G.L. c. 91

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Revenue, the State Tax Commission was charged with interpreting tax statutes on behalf of the Commonwealth. *See* St. 1953, c. 654; G.L. c. 14, §§ 3-4 (1953) (*superseded by* G.L. c. 14, §§ 3, 6 (1978)). The Chairman of the State Tax Commission was the approximate equivalent of today's Commissioner of Revenue.

App., § 1-17 (Massachusetts Port Authority). Thus there can be no doubt that Ruling 1958-7 would also include the later-created MBTA, UMBA and MHFA in the list of instrumentalities which are exempt by statute. The ruling specifically excluded from gross income interest on bonds of such Authorities.

Ruling 1958-7 has never been revoked. It is still outstanding. The Commissioner of Revenue did not issue any public statement contrary to Ruling 1958-7 until the mid-1980's (after *Memphis Bank*), when he issued Letter Ruling 84-61 and Technical Information Release 85-6. Neither of these documents was a regulation promulgated in accordance with Mass. G.L. c. 30A, the state's equivalent of the Administrative Procedure Act. Consequently, these measures were not sufficient to revoke a longstanding ruling of the State Tax Commission. Moreover they were issued long after Petitioners had acquired the Authority bonds at issue here, and had paid the taxes in question.

In conjunction, the Authority enabling acts and the 1958 ruling – both intended to induce the reliance of bond purchasers – create a contract between bondholders and the state that is binding on the state under the Contracts Clause. Acting unilaterally, the Commissioner of Revenue has abandoned Ruling 1958-7 with the specific intent to tax Authority bond interest that the Legislature earlier declared exempt. This is impermissible under this Court's precedents. *Macallen* held that alteration of the tax structure in order to reach bond income that was earlier declared exempt violates the Contracts Clause.

Although the Supreme Judicial Court held that Section 22A does not violate any covenant actually created by Massachusetts law, it is well settled that whether a contract exists for Contracts Clause purposes is a question that is subject to review by this Court. *See, e.g., Indiana ex. rel. Anderson v. Brand*, 303 U.S. 95, 100 (1938) ("In order that the [Contracts Clause] not become a dead letter, we are bound to decide for ourselves whether a contract was made, what are its terms and conditions,

and whether the State has, by later legislation, impaired its terms and conditions.") This Court should grant the writ to clarify the continuing validity of its decisions protecting contracts created by state legislation that promises tax immunity.

Where a state legislature acts to impair a contract made with the state itself, the state must show that its action serves a public necessity and that there are no available alternatives; otherwise, that action violates the Contracts Clause. *Allied Structural Steel Company v. Spannaus*, 438 U.S. 234 (1978); *U.S. Trust Co. v. New Jersey*, 431 U.S. 1 (1977); *City of El Paso v. Simmons*, 379 U.S. 497 (1965). The Commissioner of Revenue's attempt to tax Authority bonds here impairs a covenant made by the Massachusetts Legislature. There is no public necessity for Massachusetts to tax Authority bond interest, and thus the Commissioner's action violates the Contracts Clause. If Massachusetts needs the money it can raise the money by other and proper means.

Furthermore, there is no indication that the Massachusetts Legislature intended to subject Authority bonds to tax when it enacted Section 22A. There is no evidence that the Legislature considered this issue. If it did, the most likely hypothesis is that, itself relying on Ruling 1958-7, it thought that Section 22A would not reach Authority bond interest. Thus only the Commissioner of Revenue has acted to tax Authority bond interest, reversing without authority the position taken by his predecessor in Ruling 1958-7. Where only the Commissioner of Revenue, and not the Legislature, takes action that impairs contractual obligations, such action cannot possibly pass muster under the Contracts Clause. *Cf. U.S. Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

Once it is established that the interest on bonds of Massachusetts Authorities is exempt under Section 22A by virtue of the Contracts Clause, it necessarily follows that Section 22A is discriminatory against federal obligations within the meaning of 31 U.S.C. § 742. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983). As a result,

Section 22A cannot reach the interest on United States Government obligations. *Id.*

Because a state tax must include the interest on all state bonds in order to reach interest on federal bonds, there will be a continuing stream of attempts to tax state bond interest that was made exempt by state statute, and therefore of cases challenging those attempts. These challenges have great significance for state budgets, and this Petition presents an excellent test case and an opportunity for this Court. This case fairly and appropriately tests whether it is a violation of the Contracts Clause to include interest of tax-exempt state bonds in the measure of a so-called franchise tax; whether it matters if the tax is imposed by administrative action without benefit of statute; and whether the states are free, as some of them think they are, to ignore or flout this Court's *Complete Auto Transit* decision by defending the constitutionality of such taxation through the manipulation of labels.

CONCLUSION

The two questions raised by this Petition arise (and will continue to arise) frequently in the courts of states across the nation. Taxes on bond income are an important source of revenue for many states and state courts have gone very far to uphold those taxes. The applicable legal doctrine is marked by confusion and a degree of disingenuousness amounting to willful evasion of rules established by Congress and this Court. Petitioners' case is deserving of certiorari because (i) it presents a clear test of the meaning and limits of the statutory term "franchise tax" in light of *Northwestern Mutual Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927), and *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977); and (ii) it presents a clear test of the Contracts Clause in light of the enabling acts of the Massachusetts Authorities, which are closely comparable to provisions in other states. For the foregoing reasons, Petitioners Liberty Mutual Insurance Company and

Liberty Mutual Fire Insurance Company respectfully urge this Court to review the decision of the Supreme Judicial Court of Massachusetts.

Respectfully submitted,

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Liberty Mutual Fire Insurance Company

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APPENDIX A

LIBERTY MUTUAL INSURANCE COMPANY vs. COMMISSIONER OF REVENUE.
(and nine companion cases[1]).

Suffolk, March 6, 1989. – July 11, 1989.

Present: LIACOS, C.J., WILKINS, ABRAMS, LYNCH, O'CONNOR, JJ.

Taxation, Insurance Company excise. *Constitutional Law,* Taxation, Equal protection of laws.

The State excise tax imposed on domestic insurance companies by G. L. c. 63, § 22A, is a "nondiscriminatory franchise or other non-property" tax permitted under 31 U.S.C. § 3124 (a), with the result that interest earned by insurance companies on Federal obligations were subject to taxation. [354-356]

Where G. L. c. 63, § 22A, setting forth the provisions of a State excise tax, requires the interest earned on both

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[1] Five appeals by Liberty Mutual Fire Insurance Company were before the Appellate Tax Board. Four other appeals by Liberty Mutual Insurance Company were also before the board. The board rendered one decision for the cases. See note 3, *supra.*

The plaintiffs have requested we await the outcome of a bank tax case currently awaiting decision by the board. We deny that request.

We acknowledge the assistance of the amicus brief of Baybank Middlesex and its affiliates, and State Street Bank and Trust Company.

State and Federal obligations to be included in calculating the base on which the tax is levied, the excise tax was not discriminatory and did not conflict with the provisions of Federal law set forth in 31 U.S.C. § 3124 (a). [357]

The State excise tax imposed on domestic insurance companies by G. L. c. 63, § 22A, does not violate the contracts clause of the United States Constitution. [357]

The power of the Commissioner of Insurance exercisable under the provisions of G. L. c. 63, § 22A, does not constitute an unlawful delegation by the Legislature of its taxing power. [358]

The distinctions among taxpayers set forth in the State excise tax statute, G. L. c. 63, § 22A, had a rational basis, thus were not vulnerable to challenge under the equal protection clause or under Part II, c. 1, § 1, art. 4, of the Massachusetts Constitution, which prohibits unreasonable taxes. [358-359]

APPEAL from a decision of the Appellate Tax Board.

The Supreme Judicial Court on its own initiative transferred the case from the Appeals Court.

Mark A. Michelson (Samuel B. Bruskin & James F. Whipple with him) for the taxpayers.

Thomas A. Barnico, Assistant Attorney General, for the Commissioner of Revenue.

Edward F. Hines, Jr., & Robert M. Buchanan, Jr., for Baybank Middlesex & others, amici curiae, submitted a brief.

ABRAMS, J. Liberty Mutual Insurance Company and Liberty Mutual Fire Insurance Company (companies) appeal from a decision of the Appellate Tax Board (board). The board upheld the decision of the Commissioner of Revenue (Commissioner), who denied the companies' applications for abatement on the excise tax imposed on domestic insurance companies by G. L. c. 63, § 22A (1986 ed.).[2] The companies argue that the excise tax imposed by G. L. c. 63, § 22A, violates various provisions of the Federal and State Constitutions. We transferred the cases to this court on our own motion. We affirm the board's decision.

The companies are domestic insurance companies within the meaning of § 22A. Both companies filed excise tax returns for the taxable years ending in 1975.[3] As § 22A requires, the companies included in their total gross

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[2] General Laws c. 63, § 22A, provides in relevant part: "Every domestic insurance company coming within the scope of the definition of a domestic company in section one of chapter one hundred and seventy-five . . . shall annually pay, as part of its excise imposed under this chapter, an amount equal to one per cent of its total gross investment income earned during the preceding calendar year, as reported in its annual statement for said year filed with the commissioner of insurance and as shown in Exhibit 3 of said statement for a life insurance company or in Item 10, Column 8, Part 1, of the Underwriting and Investment Exhibit for any other domestic insurance company."

An excise tax is a tax on the performance of an act, the conduct of an occupation, or the enjoyment of a privilege, as opposed to a tax on income. See, e.g., *Boston Safe Deposit & Trust Co. v. Commissioner of Corps. & Taxation*, 309 Mass. 37, 43 (1941); Black's Law Dictionary 506 (5th ed. 1979).

[3] The parties have agreed to use 1975 as an appropriate test year for the issues raised by the companies.

investment incomes the interest from Federal bonds, treasury notes, and other Federal obligations, as well as interest on bonds exempt from taxation under Massachusetts law. The companies paid taxes which reflected the interest on the Federal and State obligations. The companies then applied to the Commissioner for abatement of the entire excise tax for the years 1971-1977. The Commissioner refused to abate the excise tax, and the board upheld the Commissioner's decision.[4]

1. *Supremacy clause.* The companies argue that § 22A violates the supremacy clause of the United States Constitution because it conflicts with a Federal statute, 31 U.S.C. § 3124(a).[5] This statute exempts all Federal bonds and other Federal obligations from all taxation except for "nondiscriminatory franchise or other non-property

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[4] The accuracy or computation of the amounts of the excise taxes assessed, reported or paid for each tax year is not before us.

[5] Title 31 U.S.C. § 3124(a) provides in relevant part: "Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." In 1975, this statute was codified at 31 U.S.C. § 742.

taxes." *Id.*[6] The companies argue that the State excise tax of G. L. c. 63, § 22A, does not fall within the exception in the Federal statute and therefore § 22A impermissibly conflicts with the Federal exemption for Federal bonds and obligations. The Commissioner argues that the Massachusetts excise tax of § 22A is a "nondiscriminatory franchise or other nonproperty tax" which is expressly permitted by the terms of the Federal statute. We agree with the Commissioner.

We have already considered this issue. The precedent set by *Commissioner of Revenue v. Massachusetts Mut. Life Ins. Co.*, 384 Mass. 607, 608, 619 (1981), compels the conclusion that "[t]he tax imposed by § 22A is a 'nondiscriminatory franchise or other non-property tax permitted by [§ 3124(a)] . . . and therefore, the Commissioner is correct in [his] assertion that the interest earned on Federal obligations may properly be included in an excise tax." *Id.* at 616-617. The companies urge us to abandon our holding in *Massachusetts Mut. Life Ins. Co., supra.* We decline to do so.

"The label by which a tax is known should not control the constitutional principles by which it is judged." *Aronson v. Commonwealth*, 401 Mass. 244, 248 (1987), quoting *George S. Carrington Co. v. State Tax Comm'n*, 375 Mass. 549, 552 n.3 (1978). See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288 (1977). In *Commissioner of Revenue v.*

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[6] A franchise tax is a tax on the privilege of doing business within a State, as opposed to a tax on income. See, e.g., *First Fed. Sav. & Loan Ass'n v. State Tax Comm'n*, 372 Mass. 478, 486 (1977). *Provident Inst. for Sav. v. Commonwealth*, 259 Mass. 124, 126 (1927).

Massachusetts Mut. Life Ins. Co., we carefully looked behind the labels of the State statute to determine whether the excise tax of § 22A was a nondiscriminatory franchise or other nonproperty tax which is permitted under Federal law, or whether it was a property tax forbidden by Federal law. In our analysis, we noted that "[t]he tax measure [of § 22A] includes items that are not 'income' to the companies in the traditional sense, such as imputed home office rent, amortization of Federal investment tax credits, and earnings on assets held in connection with employee and agents' pension plans; and excludes items which are income in the traditional sense, such as capital gains. The fact that the measure of the tax mentions 'gross investment income' as reported in the annual statement does not divest the tax of its excise character. . . . Section 22A does not impose a limited income tax. Rather, it sets out a workable measure, a yardstick to calculate the value of the privilege of doing business in Massachusetts." *Id.* at 612. The United States Supreme Court has recognized that in State tax situations " 'rough approximation rather than precision' is sufficient." *International Harvester Co. v. Evatt*, 329 U.S. 416, 422 (1947), quoting *Illinois Cent. Ry. v. Minnesota*, 309 U.S. 157, 161 (1939). In enacting § 22A, "the Legislature meant to use the figure of total gross investment income as reported in the annual statement for insurance regulatory purposes as a benchmark by which to calculate the amount of excise payable for the privilege of doing business in the Commonwealth." *Commissioner of Revenue v. Massachusetts Mut. Life Ins. Co., supra* at 613-614.

The companies rely on *Northwestern Mut. Life Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927), for the proposition that

corporate excise taxes which include interest earned on Federal obligations necessarily must be struck down. The United States Supreme Court "has consistently upheld franchise taxes measured by a yardstick which includes tax-exempt income or property, even though a part of the economic impact of the tax may be said to bear indirectly upon such income or property." *Werner Mach. Co. v. Director of Div. of Taxation*, 350 U.S. 492, 535 (1956). In 1981, we also noted that, "[s]ince the 1930's . . . the Supreme Court has upheld corporate excise taxes which include income immune from direct taxation. In a series of cases, the Supreme Court ruled: '[T]he corporate excises may be measured by income immune from a direct tax thereon.' " *Commissioner of Revenue v. Massachusetts Mut. Life Ins. Co.*, *supra* at 615, quoting Powell, The Waning of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 633, 633 (1945). We therefore continue to adhere to our conclusion that § 22A is a franchise or other nonproperty tax.[7]

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[7] Some State courts have reached similar conclusions. See, e.g., *Department of Revenue* v. *First Union Nat'l Bank*, 513 So. 2d 114, 119 (Fla. 1987), appeal dismissed, 108 S. Ct. 1253 (1988); *State Dep't of Assessments & Taxation* v. *Maryland Nat'l Bank*, 310 Md. 664 (1987), appeal dismissed, 108 S. Ct. 2812 (1988); *Centerre Bank* v. *Director of Revenue*, 744 S.W.2d 754 (Mo. 1988); *Garfield Trust Co.* v. *Director of Taxation*, 102 N.J. 420, 434, appeal dismissed, 479 U.S. 925 (1986). These cases all hold that franchise taxes based on a measure including interest from Federal and State obligations qualify under 31 U.S.C. § 3124(a) as "nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations."

The cases cited by the plaintiffs do not compel the opposite conclusion. See, e.g., *First Fed. Sav. & Loan Ass'n* v. *Commonwealth*, 515 Pa. 369 (1987) (under Pennsylvania law, statute providing that thrift institutions "shall pay . . . State excise

(Continued on following page)

The companies argue, however, that, even if § 22A is a franchise tax, it is a discriminatory franchise tax and thus not permitted by the Federal statute. The companies assert that § 22A discriminates between Federal and State obligations because Massachusetts law forbids any tax on the interest of State obligations, and thus only Federal obligations are taxed pursuant to § 22A. The short answer to this peculiar argument is that, contrary to the companies' assertion, § 22A requires taxpayers to include in their excise tax base the interest on State obligations as well. Concededly, the enabling acts of certain State authorities exempt State bonds issued by those authorities from taxation on income or property.[8] However, these State obligations are not exempt from forming part of the

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tax . . . upon . . . annual net earnings or income, for the privilege of doing business in [Pennsylvania]" could not be read to require inclusion of interest from State obligations); *Dale Nat'l Bank v. Commonwealth*, 502 Pa. 170 (1983) (tax, as calculated, was a property tax and not a franchise tax); *Federal Prods. Corp.* v. *Norberg*, 429 A.2d 447, 450 (R.I. 1981) (interest from Federal securities could not be included in income for assessment of business corporation tax, as opposed to corporate franchise tax).

[8] For example, the enabling acts of the following authorities exempt the bond interest of the authorities from State taxation: the Massachusetts Bay Transportation Authority, G. L. c. 161A, § 18 (St. 1964, c. 563, § 18); the University of Massachusetts Building Authority, St. 1960, c. 773, § 15; and the Massachusetts Housing Finance Agency, St. 1966, c. 708, § 12. During the years with which we are concerned, the companies held bonds of these three authorities.

base on which an excise tax is levied on the privilege of doing business in Massachusetts. See, e.g., *Commissioner of Revenue* v. *Massachusetts Mut. Life Ins. Co., supra* at 617-618 (tax exempt status of income derived from projects pursuant to c. 121A, did not prevent inclusion in the tax base for excise tax purposes).

This conclusion disposes of the companies' argument that the Commissioner's attempt to tax Massachusetts authority bonds impairs a "covenant" made by the Legislature that the bonds remain free from taxation. According to the companies, this impairment violates the contracts clause of the United States Constitution. Art. 1, § 10, of the Constitution of the United States. However, we have concluded above that the fact that the tax base for the excise of § 22A includes the interest earned on State bonds does not mean that the Legislature has imposed a property tax on these bonds. Therefore, no covenant has been broken.

Because § 22A constitutes a "nondiscriminatory franchise or other nonproperty" tax within the meaning of 31 U.S.C. § 3124(a), the imposition of this excise tax does not conflict with Federal law.

2. *Delegation of taxing power.* The companies argue that § 22A grants the Commissioner "the absolute power to determine the excise tax unchecked by any clear statement of policy, and without any judicial or administrative supervision whatsoever." The companies therefore assert that § 22A embodies a delegation by the Legislature of its taxing power in violation of the Massachusetts Constitution. We do not agree. This argument also is precluded by *Commissioner of Revenue* v. *Massachusetts Mut. Life Ins. Co.,*

supra. There we held that under § 22A, "[t]he Commissioner of Insurance does not include or exclude items in the annual statement for the purpose of affecting the amount of the excise tax, but rather for the purpose of regulating the companies. His power to affect the amount of tax payable under the formula established by the Legislature is purely incidental to those regulatory powers. The taxing power remains with the Legislature as provided in the State Constitution. Part II, c. 1, § 1, art. 4, of the Massachusetts Constitution." *Id.* at 610.

3. *Equal protection and reasonableness*. The companies assert that § 22A discriminates against domestic insurance companies by taxing them more heavily than foreign companies and other types of domestic businesses. The companies argue that § 22A, therefore, violates their rights to equal protection of the laws under the Fourteenth Amendment to the United States Constitution and their right to be free from unreasonable taxation under Part II, c. 1, § 1, art. 4, of the Massachusetts Constitution. We do not agree.

"Any distinction in a tax statute that has a rational basis will survive a challenge under the equal protection clause." *Smith* v. *Commissioner of Revenue*, 383 Mass. 139, 141 (1981). See *Seiler Corp.* v. *Commissioner of Revenue*, 384 Mass. 635, 639 (1981). Assuming without deciding that the taxpayers bear a heavier burden than foreign insurance companies doing business in Massachusetts, it is not unreasonable to tax domestic insurance companies differently. The Legislature could rationally decide that the benefits the State accords to domestic insurance companies justify treating them differently from foreign insurance companies. See *Mary C. Wheeler School, Inc.* v.

Assessors of Seekonk, 368 Mass. 344, 346-350 (1975). The Legislature could also rationally conclude that the nature of the insurance business warrants treating insurance companies differently from other types of companies. See *Massachusetts Auto. Rating & Accident Prevention Bureau* v. *Commissioner of Ins.*, 381 Mass. 592, 604-605 (1980).

Similarly, the companies' argument that § 22A is an unreasonable tax in violation of Part II, c. 1, § 1, art. 4, of the Massachusetts Constitution is without merit. "[T]he Legislature's choice of gross investment income as reported for regulatory purposes as a rough approximation of the value of the privilege of doing business in the Commonwealth is reasonable." *Commissioner of Revenue* v. *Massachusetts Mut. Life Ins. Co.*, *supra* at 613.

The decision of the board is affirmed.

So ordered.

APPENDIX B

COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

LIBERTY MUTUAL INSURANCE CO.	v.	COMMISSIONER OF REVENUE
LIBERTY MUTUAL FIRE INSURANCE CO.	v.	COMMISSIONER OF REVENUE

Docket Nos. 86036, 86037
122512, 122513, 122514, 122515, 125133, 125134, 125135, 125136

Promulgated: May 2, 1988

This is an appeal under the formal procedure pursuant to G.L. c.62C s.39, as amended, from the refusal of the appellee to abate insurance company excises assessed under G.L. c.63 s.22A for the periods 1971 through 1977.

These findings of fact and report are made pursuant to a request by the appellants under G.L. c.58A s.13, as amended, and Rule 32 of the Rules of Practice and Procedure of the Appellate Tax Board.

Mark A. Michelson, Esq., for the appellant.

Robert A. Carleo, Jr., Esq., for the appellee.

FINDINGS OF FACT AND REPORT

The appellants are domestic insurance companies as defined in G.L. c.175 s.1, and each has its principal place of business in Massachusetts. Each filed its domestic insurance company premium excise return on Form 63-22

for its taxable year ending December 31 of each of the years 1971 through 1977. Form 63-22 includes the information required for assessment of the excise on total gross investment income levied by G.L. c.63 s.22A. The board's findings are based on a Statement of Agreed Facts covering returns for each appellant's 1975 taxable year, which the parties agree is an appropriate test year for the issues raised for all the tax years at issue.

Liberty Mutual omitted from its 1975 return imputed home office rental included in Part I, column 8, line 10 of the Underwriting and Investment Exhibit of its annual statement filed with the Commissioner of Insurance. The Commissioner of Revenue assessed an additional excise, which Liberty Mutual paid, based on the inclusion of the imputed home office rent in the total gross investment income. Liberty Mutual and Liberty Fire each included in its total gross investment income interest earned from bonds, Treasury Notes, and other United States obligations, as well as interest on bonds which were exempt from taxation under Massachusetts law, and paid the excises resulting from the inclusion of these items. Each appellant made timely application for abatement of its entire excise on gross investment income. The appellee denied all of the applications, and the appellants filed timely appeals to the Appellate Tax Board.

There is no dispute that the items at issue were reportable on the Underwriting and Investment Exhibit of the annual statement filed with the Commissioner of Insurance. The board finds that the items were reportable and that the appellants reported them with their annual statements.

Insofar as it is a question of fact, the board finds that the items of investment income at issue were properly includible in the excise assessments based on the appellants' gross investment income and that the appellee correctly assessed the excise under G.L. c.63 s.22A.

OPINION

The excise whose assessments are the subject of these appeals is imposed by G.L. c.63 s.22A, which provided in pertinent part as follows during the years in question:

> Every domestic insurance company coming within the scope of the definition of a domestic company in section one of chapter one hundred and seventy-five shall annually pay, as part of its excise imposed under this chapter, an amount equal to one per cent of its total gross investment income earned during the preceding calendar year, as reported in its annual statement for said year filed with the commissioner of insurance and as shown . . . in Item 10, Column 8, Part I, of the Underwriting and Investment Exhibit. . . .

The appellants raise the following challenges to the assessments of their gross investment income made under this provision:

1. The inclusion of interest from federal obligations violates the Supremacy Clause of Article VI of the United States Constitution because it taxes income from federal obligations in conflict with 31 USC s.742;

2. The inclusion of interest from obligations of Massachusetts governmental authorities conflicts with exemption provisions of the authorities' enabling statutes and violates

the Contracts Clause of the United States Constitution;

3. The method provided for determining gross investment income delegates the taxing power of the General Court in violation of the Massachusetts Constitution;

4. The excise is not a reasonable excise within the taxing power granted to the General Court by the Massachusetts Constitution.

Inclusion of Interest from Federal Obligations

Article VI of the United States Constitution provides in part:

> This constitution, and the laws of the United States which shall be made in pursuance thereof . . . shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or laws of any state to the contrary notwithstanding.

During the years at issue Rev. Stat. s.3701 (codified then as 31 U.S.C. s.742, now as 31 U.S.C. s.3124(a)), provided as follows:

> Except as otherwise provided by law, all stocks, bonds, Treasury Notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, *except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations*. . . . [Emphasis added.]

The Supreme Court's decisions "have treated s.742 as principally a restatement of the constitutional rule." *Memphis Bank & Trust*, 459 U.S. 392, 397 (1983); *First Nat. Bank of Atlanta*, 470 U.S. 583, 593 (1985).

In *Northwestern Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927), the United States Supreme Court held that an annual license fee of 3% of gross income could not validly be applied to interest from federal obligations. Distinguishing a tax on gross income from a tax on net income, the court pointed out that the state statute "undertook to impose a charge of 3 per cent. upon every dollar of interest received by the Company from United States bonds" and thus amounted to "an imposition upon the bonds themselves" and went "beyond the power of the State." 275 U.S. at 141. In more recent cases the Court has struck down state franchise taxes which discriminated against federal obligations by including the obligations themselves or the income earned on them in the tax base while exempting state obligations. *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929); *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983). *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983), which the appellants cite, expressly distinguishes the tax on bank shares involved in that case from a franchise tax and acknowledges that "Congress must have believed that franchise . . . taxes required federal obligations to 'be considered, directly or indirectly, in the computation of the tax'; otherwise, the specific exemptions for these taxes would have been superfluous." 463 U.S. AT 864.

The Supreme Court has consistently held, however, that Rev. Stat. s.3701 did not prohibit the imposition of nondiscriminatory taxes on franchises, even if the value

of the franchise was measured by assets, including federal obligations. Thus, under the statute permitting states to tax the net income of national banks, the Supreme Court held that a state tax on the net income of national banking associations, including tax-exempt income from federal securities and not discriminating between exempt and non-exempt income, did not unconstitutionally tax the exempt income. *Tradesmens Nat. Bank v. Oklahoma Tax Comm.*, 309 U.S. 560 (1940). In *Werner Machine Co. v. Director of Div. of Taxation*, 350 U.S. 492 (1956), the Supreme Court upheld a nondiscriminatory tax on domestic corporations, found by the state's highest court to be a bona fide franchise tax, which was measured by the "net worth" of the corporation, including federal bonds. The Supreme Court has also held that the requirements of Rev. St. s.3701 were satisfied for purposes of a tax on the fair market value of bank shares (determined by dividing the bank's net worth by the number of outstanding shares) by deducting from net worth only the percentage of assets attributable to federal obligations rather than the full value of the obligations, where on the bank's balance sheet some of the federal obligations were represented by liabilities and some by net worth. *First Nat. Bank of Atlanta v. Bartow County Board of Tax Assessors*, 470 U.S. 583 (1985). "In sum, ever since Gehner [*Missouri ex rel. Missouri Ins. Co. v. Gehner*, 281 U.S. 313 (1930)], each time this Court has addressed the scope of the tax exemption for Government obligations, it has concluded that the exemption need not be a total exclusion, but, instead, may be limited by charging tax-exempt obligations and interest their fair share of related expenses or burdens." 470 U.S. at 593.

Since we do not accept the appellants' contention that income from obligations of various Massachusetts governmental authorities is exempt from the excise imposed by G.L. c.63 s.22A, we do not find that the excise discriminates against federal obligations.

Finally, the inclusion of income from federal obligations in the measure of the excise under review has already been upheld by the Supreme Judicial Court of the Commonwealth in *Commissioner of Revenue v. Massachusetts Mutual Life Ins. Co.*, 384 Mass. 607 (1981). In its discussion of this issue the Court stated, "Historically, it appears that in the early part of the century the Supreme Court struck down corporate excise taxes that included interest earned on Federal obligations. *Northwestern, supra* [275 U.S.] at 141 (corporate excise tax measured by 'gross income from all sources'). *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929) (corporate excise tax measured by net income). Since the 1930's, however, the Supreme Court has upheld corporate excise taxes which include income immune from taxation. In a series of cases the Supreme Court ruled: '[T]he corporate excises may be measured by income immune from a direct tax thereon.' [Citations omitted.] . . . We conclude that the tax imposed by s.22A is a 'nondiscriminatory franchise or other nonproperty tax,' permitted by s.742, . . . and therefore, the Commissioner is correct in her assertion that the interest earned on Federal obligations may properly be included in the excise tax." 384 Mass. at 615-617.

Inclusion of Interest from Massachusetts Obligations

The appellants held bonds of the Massachusetts Bay Transportation Authority (MBTA), the University of Massachusetts Building Authority (UMBA), and the Massachusetts Housing Finance Agency (MHFA), all of whose enabling acts expressly exempt income from authority bonds from taxation. For the MBTA, G.L. c.161A s.18 (St. 1964 c.563 s.18) provides:

> Bonds and notes issued by the authority, their transfer and the income therefrom, including any profit made on the sale thereof, shall at all times be free from taxation within the commonwealth.

For the UMBA, St. 1960 c.773 s.15 provides:

> [T]he notes and bonds issued under the provisions of this act, their transfer and the income therefrom, including any profit made on the sale thereof, shall at all times be free from taxation within the commonwealth.

For the MHFA, St. 1966 c.708 s.12 provides:

> The commonwealth covenants with the purchasers and all subsequent holders and transferees of the notes and bonds issued by the MHFA, in consideration of the acceptance of any payment for the notes and bonds, that the notes and bonds of the MHFA, issued pursuant to this act and the income therefreom (sic) shall at all times be free from taxation.

The appellants contend that the Commissioner's inclusion of the interest on bonds of these agencies in the measure of the excise violates the plain meaning of the exemption language quoted above. They also argue that the Commissioner's interpretation of G.L. c.63 s.22A is

contrary to Corporation Excise Tax Ruling 1958-7, which expressly stated that interest on authority bonds was not a part of gross income under G.L. c.63 s.30(5) for purposes of the corporation excise where the authority's enabling act provided for an exemption from taxation within the Commonwealth. While the appellants offer this Ruling as an interpretation of the exemption provision of an enabling act, we regard it rather as an interpretation of the definition of gross income for the corporation excise. Insurance companies are engaged in a highly specialized business for which the Legislature could have provided and did provide a different measure in establishing its excise structure. Any inference that the Legislature "acquiesced in the result reached in the ruling when it later used the same language in enacting the exemption legislation at issue" (Consolidated Memorandum p. 16) would overlook this point and would at best be speculative.

The appellants also argue that although the tax is in form an excise, in substance and effect it is a tax on any interest derived from tax-exempt bonds because its amount varies directly with the amount of bond interest included in gross investment income. This argument is answered by the Court's statements quoted above from *Massachusetts Mutual* on interest from federal obligations.

The Supreme Judicial Court has upheld the inclusion of income derived from urban redevelopment projects, which were entitled to choose an excise as an alternative to the property tax, in gross investment income under G.L. c.63 s.22A. *Commissioner of Revenue v. Massachusetts Mut. Life Ins. Co*, 384 Mass. 607 (1981). This board has sustained the inclusion of interest from MHFA bonds in

net income for purposes of the bank excise imposed by G.L. c. 63 ss.1 and 2. *Capital Bank and Trust Co. v. Commissioner of Revenue,* Docket No. 120846, 3 Mass. A.T.B. Rep. 143, 1983 A.T.B. Advance Sheets 504 (October 18, 1983).

The appellants also contend that the inclusion of Massachusetts governmental authority bond interest in gross investment income subject to the excise violates the Contracts Clause (Art. I s.10 cl.1) of the United States Constitution. The excise is not levied on the bonds or their interest, however, but on the privilege of doing business in Massachusetts. *Commissioner of Revenue v. Massachusetts Mut. Life Ins. Co.,* 384 Mass. 607, 618 (1981).

In a case which, unlike *Macallen Co. v. Massachusetts, supra,* did not involve an extension of an existing tax to income previously exempt, the United States Supreme Court has held that a corporate franchise tax based on net income, including income from tax-exempt municipal bonds and making no discrimination between exempt and non-exempt income, did not impair contract obligations. *Pacific Co. v. Johnson,* 285 U.S. 480 (1932).

Delegation of Taxing Power

The appellants contend that G.L. c.63 s.22A gives the Commissioner of Insurance complete discretion over the items required to be included in total gross investment income on the annual statement, thereby conferring on him the power to determine the amount of tax due, and that since no opportunity is provided for administrative or judicial review of the exercise of this discretion, the authority given to the Commissioner of Insurance violates the prohibition against delegation of the legislative

power of taxation. See *Emerson College v. City of Boston*, 391 Mass. 415, 422 n.14 (1984).

The appellants do not appear to argue, however, that the action of the Commissioner of Insurance was improper for any reason other than the resulting inclusion of the items in question in gross investment income subject to the excise. What is at issue in these appeals is not whether the Commissioner of Insurance could properly require the inclusion of the items in question as part of the annual statement filed with him, but whether the items required to be so included could properly be also included in gross investment income for purposes of the excise imposed by G.L. c.63 s.22A. As the appellants say, G.L. c.175 s.25 provides no appeal on the propriety of the action of the Commissioner of Insurance. On the propriety of the assessment of the excise, however, the tax statutes give the taxpayers the benefit of administrative proceedings before the Commissioner of Revenue and the Appellate Tax Board, of both of which they have availed themselves, and of eventual judicial review. G.L. c.58A ss.6, 13; c.62C ss.37, 39. Although the appellants correctly point out that the Supreme Judicial Court did not consider the lack of opportunity to appeal the action of the Commissioner of Insurance in *Massachusetts Mutual, supra*, the point had no greater relevance there than here, since the Court held that the legislature had not improperly delegated the legislative power to tax. As the Court said, "The Commissioner of Insurance does not include or exclude items in the annual statement for purposes of affecting the amount of the excise tax, but rather for the purpose of regulating the companies. His power to affect the amount of tax payable under the formula established

by the Legislature is purely incidental to those regulatory powers. *The taxing power remains with the Legislature as provided in the State Constitution.*" 384 Mass. at 610 (emphasis added).

Reasonableness of Excise

The Massachusetts Constitution (Part II, c.1, s.1, art. 4) empowers the General Court to levy "reasonable excises" only. The appellants argue that the excise imposed by G.L. c.63 s.22A fails to meet this standard because it applies only to domestic insurance companies and not to foreign insurance companies or to domestic companies engaged in other businesses, and that the distinction is not justified by any additional benefit derived by domestic insurance companies from the privilege of doing business in Massachusetts. See *In re Suffolk Savings Bank for Seamen*, 151 Mass. 103, 105 (1890). In the *Massachusetts Mutual* case the Court said: "We believe that the Legislature's choice of gross investment income as reported for regulatory purposes as a rough approximation of the value of the privilege of doing business in the Commonwealth is reasonable." 384 Mass. at 613. Although the Court was speaking directly of the items included in gross investment income, the board believes that under the *Massachusetts Mutual* case and the other cases cited therein, the Legislature has considerable latitude in approximating the value of a privilege without calculating its exact relation to the values of other privileges exercised by other classes of taxpayers. G.L. c.63 imposes different excises on various classes of corporations for the privilege of doing business in Massachusetts,

and many of them distinguish between domestic and foreign corporations.

Similar considerations apply to the appellants' argument that the limitation of the excise on domestic insurance companies violates equal protection under the United States Constitution. "So long as any basis of fact can be reasonably conceived showing that the distinction made by a tax statute has a fair and rational relationship to the object sought to be accomplished, the legislative classification is not violative of equal protection principles. *Frost v. Commissioner of Corps. & Taxation*, 363 Mass. 235, 248 (1973)." *Seiler Corp. v. Commissioner of Revenue*, 384 Mass. 635, 639 (1981); see also *Smith v. Commissioner of Revenue*, 383 Mass. 139, 134 (1981). "[I]n taxation, even more than in other fields, legislatures possess the greatest freedom in classification. . . .The burden is on the one attacking the legislative arrangement to negative every conceivable basis which might support it." *Madden v. Kentucky*, 309 U.S. Mass. 83, 88 (1939).

Although the appellee's brief defends the inclusion of the imputed rental value of the appellants' home office in the gross investment income measure of the excise, the appellant does not appear to contest the point, and the board considers it settled by the *Massachusetts Mutual* case.

The board's decisions for the appellee were promulgated on June 30, 1987.

APPELLATE TAX BOARD

By /s/ John J. Wall Chairman

A True Copy

Attest: /s/ Illegible
Clerk of the Board

APPENDIX C

COMMISSIONER OF REVENUE

vs.

MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY & others.[1]

Suffolk. September 16, 1981. – November 17, 1981.

Present: HENNESSEY, C.J., LIACOS, ABRAMS, & LYNCH, JJ.

Taxation, Insurance company excise. *Constitutional Law,* Taxation.

General Laws c. 63, § 22A, which imposes on a domestic insurance company an excise in an amount equal to one per cent of its total gross investment income, "as reported in its annual statement . . . filed with the Commissioner of Insurance," does not constitute an improper delegation of the legislative taxing power to the Commissioner of Insurance. [609-611]

Under G. L. c. 63, § 22A, the excise tax to be paid by domestic insurance companies is measured by total gross investment income as reported in the annual statements filed by the companies for insurance regulatory purposes even though such a measure may include items which are not gross investment income in the tax sense and exclude items that are gross investment income in the tax sense. [611-614]

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[1] The other defendants are New England Mutual Life Insurance Company and State Mutual Life Assurance Company of America.

The interest earned on Federal obligations may properly be included in "gross investment income" for the purposes of the excise tax imposed on domestic insurance companies by G. L. c. 63, § 22A, because it is a nondiscriminatory franchise tax. [614-617]

The income derived from urban redevelopment projects pursuant to G. L. c. 121A may properly be included in "gross investment income" for the purposes of the excise tax imposed on domestic insurance companies by c. 63, § 22A, since it does not constitute a direct tax upon that income but rather on the general corporate privilege of doing business. [617-618]

Income from separate account business is not part of the "total gross investment income" of domestic insurance companies for purposes of the excise tax imposed by G. L. c. 63, § 22A. [618-619]

Although items such as the fair rental value of home office buildings, earnings on assets held in connection with employee and agents' pension plans, and the amortization of Federal investment tax credits are not traditional items of income, they may properly be included in "gross investment income" for purposes of the excise tax imposed on domestic insurance companies by G. L. c. 63, § 22A. [619]

APPEAL from a decision by the Appellate Tax Board.

Stephen S. Ostrach, Assistant Attorney General, for he plaintiff.

Robert W. Meserve & Mark A. Michelson (Robert J. McGee & John N. Garner with them) for the defendants.

ABRAMS, J. The Commissioner of Revenue appeals from a decision of the Appellate Tax Board (board), which granted three domestic insurance companies an abatement on an excise tax imposed by G. L. c. 63, § 22A, inserted by St. 1971, c. 555, § 27.[2]

The three companies are domestic insurance companies within the meaning of § 22A. Each of the companies filed with the Commissioner of Insurance an annual statement of their financial condition pursuant to G. L. c. 175, § 25, and with the Commissioner of Revenue (Commissioner)[3] an excise tax return pursuant to § 22A for the year 1971. The excise tax returns reported a lesser amount of "total gross investment income" than the amount shown on exhibit 3 of the annual statements. The Commissioner notified the companies that he intended to

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[2] General Laws c. 63, § 22A, provides: "Every domestic insurance company coming within the scope of the definition of a domestic company in section one hundred and seventy-five shall annually pay, as part of its excise imposed under this chapter, an amount equal to one per cent of its total gross investment income earned during the preceding calendar year, as reported in its annual statement for said year filed with the commissioner of insurance and as shown in Exhibit 3 of said statement for a life insurance company or in Item 10, Column 8, Part I, of the Underwriting and Investment Exhibit for any other domestic insurance company." This provision is effective until January 1, 1982. St. 1977, c. 816, § 29.

[3] The state Tax Commission was reorganized under the new title of Department of Revenue in 1978. St. 1978, c. 514, § 5.

increase their gross investment incomes as reported pursuant to § 22A, and to assess them accordingly.[4] The companies paid the assessed tax and applied to the Commissioner for abatement of their 1971 excise. The Commissioner denied the applications and the companies appealed to the board.

Before the board, the companies challenged the constitutionality of § 22A claiming that, if the board were to read § 22A literally, then the statute would be unconstitutional as an improper delegation of the legislative taxing power. The companies argue and the board agreed that since the Commissioner of Insurance has authority under G. L. c. 175, § 15, to determine the contents of the insurers' annual statement filed pursuant to § 25, and since the annual statement is used to determine the amount of excise tax, § 22A, in effect, gives the Commissioner of Insurance the discretion to determine the tax imposed. The board determined that the companies may have raised a valid constitutional claim. In order to avoid constitutional doubts, the board held that § 22A "does not preclude an inquiry into the nature of the items in issue to determine whether in law and in fact they are includable in the term 'total gross investment income' for excise

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[4] The increased excise was based upon the inclusion of the following items which were included in the annual statement but not in the excise tax return: (1) interest on obligations of the United States; (2) income derived from G. L. c. 121A projects; (3) income from separate account business; (4) earnings on assets held in connection with employee and agents' pension plans; (5) the fair rental value of home office buildings; (6) management fees; (7) "ex-dividends" on certain securities; and (8) amortization of Federal investment tax credits.

tax purposes, although required to be reported in any event as bearing on the company's financial condition for regulatory purposes."

The board then independently examined eight categories of income (see note 4, *supra*) and determined that the eight categories were not "gross investment income" for tax purposes.[5] The board entered a decision granting the requested abatements.

1. *The constitutionality of* § 22A. The over-all statutory pattern of § 22A does not involve the delegation of legislative authority. General Laws c. 175, § 25, permits the Commissioner of Insurance to determine the contents of the insurers' annual statement for the "purpose of eliciting a complete and accurate exhibit of the condition and transactions of the companies." Section 25 also allows the Commissioner of Insurance to adopt "the latest applicable form of annual statement approved by the National Association of Insurance Commissioners." The Commissioner of Insurance uses the information contained in this statement to discharge his "duty to exercise a broad surveillance over the operations of companies with a view to instituting procedures and recommending changes which might prevent or reduce the likelihood of unsuccessful ventures." *Commissioner of Ins. v. First Nat'l Bank*, 352 Mass, 74, 79-80 (1967).

The Commissioner of Insurance does not include or exclude items in the annual statement for the purpose of affecting the amount of the excise tax, but rather for the

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[5] Both the board and the companies concede that not all of these items are income in the traditional sense.

purpose or regulating the companies. His power to affect the amount of tax payable under the formula established by the Legislature is purely incidental to those regulatory powers. The taxing power remains with the Legislature as provided in the State Constitution. Part II, c. 1, § 1, art. 4, of the Massachusetts Constitution.

Although the Commissioner of Insurance may incidentally affect the amount of the tax payable, he may not do so except through acts of independent legal significance. "It may . . . be laid down as a general proposition that where a legislature enacts a specific rule for fixing a rate of taxation, by which rule the rate is mathematically deduced from facts and events occurring within the year and created without reference to the matter of that rate, there is no abdication of the legislative function, but, on the contrary, a direct legislative determination of the rate." *Michigan Cent. R.R. v. Powers*, 201 U.S. 245, 297 (1906). Thus, "[t]he fact that [a] deduction allowed to a Federal savings and loan association is determined by a Federal agency decision concerning reserve requirements is not an unconstitutional delegation of legislative powers in violation of . . . the Declaration of Rights of the Constitution of the Commonwealth. . . . In numerous instances a taxpayer's obligation is affected by the conduct of other persons, but those other persons are not exercising the authority of the Legislature to tax. *Their action may influence the amount of tax payable, but the taxing power has not been delegated to them*" (emphasis supplied). *First Fed. Sav. & Loan Ass'n v. State Tax Comm'n* 372 Mass. 478, 491 (1977). See *Parker Affiliated Cos. v. Department of Revenue*, 382 Mass. 256, 266 (1981) ("the prospective

incorporation of Federal tax law does not constitute impermissible delegation of legislative authority").

The companies claim that three *Opinions of the Justices* support the board's conclusion that § 22A creates "constitutional doubts." We do not agree. Those opinions involved pending legislation in which the Justices concluded that the legislative authority to enact substantive measures had been delegated. See, e.g., *Opinion of the Justices*, 334 Mass. 716 (1956) (power to appropriate funds); *Opinion of the Justices*, 328 Mass. 674 (1952) (power to make structural changes in the form of town government); *Opinion of the Justices*, 239 Mass. 606 (1921) (power to establish offense to be punished by fine or imprisonment). See *Corning Glass Works v. Ann & Hope, Inc.* 363 Mass. 409 (1973). In each of these instances the delegation of legislative authority was the major thrust of the pending legislation. We believe that § 22A differs markedly from the legislation under consideration in those *Opinions of the Justices*.

However, the Legislature has "[g]reat latitude of discretion . . . in determining . . . the standard or measure to be adopted as the foundation of the proposed excise [tax]." *Connecticut Mut. Life Ins. Co. v. Commonwealth*, 133 Mass. 161, 163 (1882). In adopting exhibit 3, the Legislature determined the standard of measure to be used. Hence, G. L. c. 63, § 22A, is not an improper delegation of the legislative power to tax.

2. *The meaning of "total gross investment income" in § 22A.* In the absence of constitutional doubts our task is to determine what the Legislature intended to subject to the excise tax by use of the words "total gross investment

income earned during the preceding calendar year, as reported in its annual statement." There is nothing in G. L. c. 63, or its legislative history, which is instructive.

The insurance companies assert that the Legislature intended to use gross investment income, in the tax sense, only to the extent that it is required to be reported in the annual statement. Thus, an item would become part of the excise tax measure only if it was both an item of actual gross income, as defined for tax purposes, *and* was required to be reported in the annual statement. Since the board was concerned with the constitutionality of § 22A, it adopted the companies' argument and went on to consider eight separate items of income included by the companies in exhibit 3 but excluded on their excise return (see note 4, *supra*).

Our analysis begins with the underlying premise that the excise tax imposed on the insurance companies by § 22A is an excise tax, not an income tax. The tax measure includes items that are not "income" to the companies in the traditional sense, such as imputed home office rent, amortization of Federal investment tax credits, and earnings on assets held in connection with employee and agents' pension plans; and excludes items which are income in the traditional sense, such as capital gains. The fact that the measure of the tax mentions "gross investment income" as reported in the annual statement does not divest the tax of its excise character. As we said in *Associated Indus. of Mass., Inc. v. Commissioner of Revenue*, 378 Mass. 657, 667 (1979): "The fact that a tax on the exercise of a privilege is adjusted in whole or in part to property values does not deprive the tax of its character as an excise." The tax at issue is imposed on the insurers

for the privilege of doing business in the Commonwealth. *State Tax Comm'n v. John Hancock Mut. Life Ins. Co.*, 341 Mass. 555, 559 (1960). Black's Law Dictionary 506 (5th ed. 1979). Section 22A does not impose a limited income tax. Rather, it sets out a workable measure, a yardstick to calculate the value of the privilege of doing business in Massachusetts.

The only limitation upon the Legislature's use of its excise taxing power is that the tax be reasonable. *Connecticut Mut. Life Ins. Co. v. Commonwealth, supra* at 163. "States are permitted to make fair approximations of the value of . . . privileges in imposing excises upon the corporations which they have created. . . . [We recognize] that in . . . State tax situations, ' "rough approximation rather than precision" is sufficient.' " *Springfield Ins. Co. v. State Tax Comm'n*, 342 Mass. 505, 513 (1961), quoting from *International Harvester Co. v. Evatt*, 329 U.S. 416, 422 (1947). We believe that the Legislature's choice of gross investment income as reported for regulatory purposes as a rough approximation of the value of the privilege of doing business in the Commonwealth is reasonable. That the excise tax measure may include items that are not gross investment income in the tax sense, and exclude items that are gross investment income in the tax sense does not make the Legislature's choice unreasonable.

Additionally, the argument advanced by the insurance companies distorts the language and form used by the Legislature. The insurance companies argue that the statute should be read as creating three independent tests. To become an element of the tax base an item must be (1) an item of gross investment income; (2) earned during the preceding calendar year; and (3) required to

be reported in the annual statement. The companies' interpretation is strained. If the Legislature had meant to adopt such a three-part test it could have adopted appropriate language. Indeed, the Legislature could have broken the section into subparts if it meant to convey such a meaning.

Instead of a three-part test, the Legislature chose a unitary concept: "total gross investment income earned during the preceding calendar year, as reported in the annual statement." The "annual statement" contains only items of gross investment income reported for regulatory purposes. By using this language, the Legislature obviously chose this regulatory figure as a rough approximation of the value of the privilege of doing business in Massachusetts. We conclude that the Legislature meant to use the figure of total gross investment income as reported in the annual statement for insurance regulatory purposes as a benchmark by which to calculate the amount of excise payable for the privilege of doing business in the Commonwealth.

3. *The items excluded by the board.* We briefly discuss the items of income excluded by the board.

a. *Interest earned on Federal obligations.* One of the items reported to the Commissioner of Insurance on the annual statement, and consequently used in measuring the amount of the excise tax, was interest on obligations of the United States. The insurance companies argue that § 22A cannot constitutionally include the interest earned on Federal obligations in the calculation of the tax base against which the excise is measured since obligations of

the United States are exempt from State taxation. The board agreed with the companies.

Both the board and the companies relied on *Northwestern Mut. Life Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927). In that case, the Supreme Court of the United States struck down a Wisconsin statute that imposed on insurance companies an annual license fee in the amount of three per cent of "gross income from all sources." *Id*, at 138. The Court held that the fee was fundamentally a tax upon gross income and not a true franchise tax: "Here the statute undertook to impose a charge of 3 per cent. upon every dollar of interest received by the Company from United States bonds. . . . This amounts, we think, to an imposition upon the bonds themselves and goes beyond the power of the State." *Id.* at 141. In its opinion the board pointed to various Supreme Court cases, see, e.g., *Pacific Co. v. Johnson*, 285 U.S. 480 (1932), in which a franchise tax measured by a percentage of *net* income was upheld. As a result, the board determined that the Supreme Court has established a distinction between an excise tax based on gross income and one based on net income. The board concluded that the tax imposed by § 22A was a direct tax on gross income and, therefore, was invalid under *Northwestern, supra.*

We think that the fundamental issue in cases concerning the validity of State excise taxes under the supremacy clause of the Constitution is not whether the measuring base relies upon gross income or net income. Rather, "the issue in the application of state statutes relating to corporations is whether the tax is a franchise tax or a property tax. If the subject of the tax is the corporate franchise, government obligations or the interest thereon may be

included in the measure of the tax. But if the subject of the tax is the capital or the property of the corporation, the tax will be deemed an invalid tax on the government obligations." J. Nowak, R. Rotunda & J. Young, Constitutional Law 370 (1978). Compare *Werner Mach. Co. v. Director of Div. of Taxation*, 350 U.S. 492 (1956), with *Society for Sav. v. Bowers*, 349 U.S. 143 (1955), and *New Jersey Realty Title Ins. Co. v. Division of Tax Appeals*, 338 U.S. 665 (1950). We agree with the Commissioner that § 22A is a tax on the corporate franchise.

Historically, it appears that in the early part of the century the Supreme Court struck down corporate excise taxes that included interest earned on Federal obligations. *Northwestern, supra* at 141 (corporate excise tax measured by "gross income from all sources"). *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929) (corporate excise tax measured by net income). Since the 1930's, however, the Supreme Court has upheld corporate excise taxes which include income immune from direct taxation. In a series of cases the Supreme Court ruled: "[T]he corporate excises may be measured by income immune from a direct tax thereon." Powell, The Waning of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 633, 633 (1945). See *Educational Films Corp. v. Ward*, 282 U.S. 379 (1931); *Pacific Co. v. Johnson*, 285 U.S. 480 (1932); *New York ex rel. N. Fin. Corp. v. Lynch*, 290 U.S. 601 (1933); *Werner Mach. Co. v. Director of Div. of Taxation*, 350 U.S. 492 (1956). See also *Home Ins. Co. v. New York*, 134 U.S. 594 (1890).

"[A] tax on the corporate franchise . . . is valid despite the inclusion of federal bonds in the determination of net worth. This Court has consistently upheld franchise taxes measured by a yardstick which includes

tax-exempt income or property, even though a part of the economic impact of the tax may be said to bear indirectly upon such income or property." *Werner Mach. Co. v. Director of Div. of Taxation*, 350 U.S. at 494.[6] In *Home Ins. Co. v. New York*, 134 U.S. 594, 599 (1890), the Supreme Court stated: "It is not a tax in terms upon the capital stock of the company, nor upon any bonds of the United States composing a part of that stock. The statute designates it a tax upon the 'corporate franchise or business' of the company, and reference is only made to its capital stock and dividends for the purpose of determining the amount of the tax to be exacted each year."

The rule established by the cases is embodied in 31 U.S.C. § 742 (1976).[7] *Reuben L. Anderson-Cherne, Inc. v. Commissioner of Taxation*, 303 Minn. 124, 128, appeal dismissed, 423 U.S. 886 (1975). We conclude that the tax imposed by § 22A is a "nondiscriminatory franchise or other nonproperty tax," permitted by § 742, see point 2, *supra*, and therefore, the Commissioner is correct in her

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[6] The Supreme Court distinguished a case upon which the board relied, *New Jersey Realty Title Ins. Co. v. Division of Tax Appeals*, 338 U.S. 665 (1950), on the basis that the tax was a direct tax on the property of the corporation. The Court stated: "*New Jersey Realty* . . . on which appellant relies, is distinguishable, in that it did not involve a franchise tax, but rather a tax whose legal incidence this Court found to be upon the intangible assets of the corporation." *Werner Mach. Co. v. Director of Div. of Taxation*, 350 U.S. 492, 494 (1956). Likewise, in *Society for Sav. v. Bowers*, 349 U.S. 143, 146 (1955), upon which the board also relied, the Court held the tax involved therein invalid stating: "No claim is made that the taxes constituted a franchise tax or some other kind of privilege tax."

[7] Section 742 reads as follows: "Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other

(Continued on following page)

assertion that the interest earned on Federal obligations may properly be included in the excise tax.

b. *Income derived from c. 121A projects.* Massachusetts Mutual and State Mutual have undertaken urban redevelopment projects pursuant to G. L. c. 121A.[8] The income derived from those projects was required to be reported in exhibit 3 of the annual statement. General Laws c. 121A, § 10, provides that Urban Redevelopment Corporations "shall not be required to pay any tax, excise, or assessment to or for the commonwealth . . . provided, however, that . . . any such corporation shall be required to pay . . . the excises and sums respectively prescribed by this section and section fifteen. . . ." The excise imposed by § 10 is in lieu of local

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(Continued from previous page)

obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, *except non-discriminatory franchise or other nonproperty taxes in lieu* thereof imposed on corporations . . . (emphasis supplied).

The legislative history makes clear that the purpose of the amendment was to clarify existing law: "the bill makes it clear that both the principal and interest on U.S. obligations are exempt from all State taxes except nondiscriminatory franchises, etc., taxes." S. Rep. No. 909, 86th Cong., 1st Sess., reprinted in [1959] U.S. Code Cong. & Ad. News 2769, 2769.

[8] General Laws c. 121A, § 2, as appearing in St. 1960, c. 652, § 2, provides in part: "[T]he provisions of this chapter will stimulate the investment of private capital in blighted open, decadent or sub-standard areas, and in the construction, maintenance and operation in such areas of needed decent safe and sanitary residential, commercial, industrial, institutional, and recreational buildings. . . ."

property taxes from which the project is exempt. *Opinion of the Justices*, 341 Mass. 760, 774 (1960).

General Laws c. 121A, § 18 (*g*), authorizes insurance companies to undertake c. 121A projects and provides: "So much of section ten as applies to the taxation of a corporation organized under section three shall apply to an insurance company only with respect to a particular project or to particular projects, and such company shall remain subject to all other taxation imposed by law with respect to its other activities and property." Since an insurance company pays an excise tax under § 10 for the privilege of undertaking c. 121A projects, the board held that the Legislature could not have intended to include c. 121A income again in the § 22A excise tax measure.[9]

The tax levied by § 22A is an excise imposed for the privilege of doing business in Massachusetts. *State Tax Comm'n v. John Hancock Mut. Life Ins. Co.*, 341 Mass. 555, 559 (1960). In order to roughly approximate the value of that privilege, *Springfield Ins. Co. v. State Tax Comm'n*, 342 Mass. 505, 513 (1961), the Legislature chose to measure the excise by gross investment income as reported for regulatory purposes. Although the figure reflects, to a certain extent, income from c. 121A projects, it does not retain that characteristic for tax purposes. As we said in *Springfield Ins.*, comparing the insurance excise in nature and impact to the excise on savings banks: " 'The subject

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[9] The board was concerned with potential problems of double taxation. See *DeBlois v. Commissioner of Corps. & Taxation*, 276 Mass. 437, 439 (1931). However, § 22A imposes a tax on the corporate franchise and raises no problems of double taxation.

to be taxed was the . . . existing value of the franchises . . . that is, the amount of benefit . . . which the charter . . . conferred on those who held it and enjoyed its privileges. . . . The excise is not laid on the business which each . . . [company] has transacted' during a preceding period, but 'upon the value of the franchise' at the end of the period." *Id*, at 508, quoting from *Commonwealth v. People's Five Cents Sav. Bank*, 5 Allen 428, 437-438 (1862).

Section 22A does not impose an excise on the privilege of undertaking any particular c. 121A project, but rather on the general corporate privilege of doing business. The excise levied by § 22A is imposed solely on the privilege of the carrying on or doing of business by the companies, and not upon the individual items used to calculate that figure. Thus, the tax exempt status of income derived from c. 121A projects does not prevent the Legislature from using it as a part of the base on which the corporate excise tax is levied.

c. *Income from separate account business.* Each of the companies handles "separate account[s]" under G. L. c. 175, §§ 132F-132H. Section 132F provides that an insurer may, by written agreement with the holders of "pension contracts," assign "such contracts and the funds received thereunder, to one or more separate investment accounts, independent of its general investment account, for the purposes of allocating investment returns and asset gains and losses." Each year the insurers file an "Annual Statement" on Form 1 and an "Annual Statement" for the separate account business on Form 1-S. The Commissioner argues that the words "as reported in its annual statement" in § 22A refer to both forms. We disagree. There is no indication in § 22A that the Legislature

intended to refer to anything but the annual statement filed on Form 1. Consequently, the income reported on Form 1-S was properly excluded by the board.

d. *Miscellaneous items.* Items such as the fair rental value of home office buildings, earnings on assets held in connection with employee and agents' pension plans, and the amortization of Federal investment tax credits were all properly reported on exhibit 3 and, consequently, were required to be reported on the excise tax return. To the extent these items are not traditional items of income, it lends support to our conclusion that this is not a limited income tax, but rather a franchise tax.[10]

The decision below is reversed and the case remanded to the board for further consideration of the plaintiffs' applications for abatement consistent with this opinion.

So ordered.

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[10] Massachusetts Mutual reported management fees on exhibit 3. Although this item could have been reported elsewhere on the annual statement, it was not incorrect to report it on exhibit 3. State Mutual did not follow the instructions of the Commissioner of Insurance as to "ex-dividends."

It is incumbent on the companies to go back to the Commissioner of Insurance it they want to correct their annual statements. Neither company did so.

APPENDIX D

COMMONWEALTH OF MASSACHUSETTS.

SUPREME JUDICIAL COURT
FOR THE COMMONWEALTH,

AT BOSTON,

July 11, 1989

IN THE CASE NO. SJC- 4993

LIBERTY MUTUAL INSURANCE COMPANY

vs.

COMMISSIONER OF REVENUE
(and nine companion cases).

pending in the Appellate Tax Board
Court for the County of Suffolk No. 86036, 86037;
122512,
122513,
122514,
122515;
125133,
125134,
125135,
125136.

ORDERED, that the following entry be made in the docket; viz., –

Decision of the Board is affirmed.

So ordered.

By The Court,

Jean M. Kennett, Clerk.

July 11, 1989

Supreme Court, U.S.
FILED
NOV 13 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-593

In the
Supreme Court of the United States

OCTOBER TERM, 1989

LIBERTY MUTUAL INSURANCE CO. AND
LIBERTY MUTUAL FIRE INSURANCE CO.,
PETITIONERS,

v.

COMMISSIONER OF REVENUE,
COMMONWEALTH OF MASSACHUSETTS.
RESPONDENT.

ON PETITION FOR WRIT OF CERTIORARI TO THE
SUPREME JUDICIAL COURT
OF MASSACHUSETTS

Respondent's Brief in Opposition

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QUESTIONS PRESENTED

1. Whether a Massachusetts tax on domestic insurance companies that is based in part on investment income reported for regulatory purposes is a "franchise tax" which may include in its measure interest on federal bonds.

2. Whether the Contracts Clause precludes a state from including interest on state bonds in the measure of a franchise tax on domestic insurance companies.

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No. 89-593

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1989

LIBERTY MUTUAL INSURANCE CO. and
LIBERTY MUTUAL FIRE INSURANCE CO.,

Petitioners,

v.

COMMISSIONER OF REVENUE,
COMMONWEALTH OF MASSACHUSETTS,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE SUPREME JUDICIAL COURT
OF MASSACHUSETTS

Pursuant to United States Supreme Court Rule 22.1, respondent Commissioner of Revenue, Commonwealth of Massachusetts (the "Commonwealth"), submits this brief

in opposition to the petition for a writ of certiorari filed by Liberty Mutual Insurance Company and Liberty Mutual Fire Insurance Company ("Liberty") in this case.

OPINIONS BELOW

The two opinions of the Supreme Judicial Court identified at page 1 of the petition are also reported at 541 N.E.2d 566 (1989), and 428 N.E.2d 297 (1981), respectively.

JURISDICTION

The judgment of the Massachusetts Supreme Judicial Court was entered on July 11, 1989. See Pet. App. D. The petition was filed on October 9, 1989, and received by the Commonwealth on

October 11, 1989. The petitioner has invoked the Court's jurisdiction under 28 U.S.C. § 1257. Pet. 2.

STATUTES INVOLVED

An accurate statement of the federal statutes and constitutional provisions involved in this case appears at pages 2-3 of the petition. As to the relevant Massachusetts statutes, the Commonwealth sets forth the full text of Mass. Gen. Laws c. 63, § 22A, as follows:

> Every domestic insurance company coming within the scope of the definition of a domestic company in section one hundred and seventy-five shall annually pay, as part of its excise imposed under this chapter, an amount equal to one per cent of its total gross investment income earned during the preceding calendar year, as reported in its annual statement for said year filed with the commissioner of insurance and as shown in Exhibit 3 of said statement for a life insurance company or in

item 10, Column 8, Part I, of the Underwriting and Investment Exhibit for any other domestic insurance company.

Mass. Gen. Laws c. 175, § 25, provides in part:

> Every company shall annually, on or before March first or sixty days from such date authorized by the commissioner, file with the commissioner a statement showing its financial condition on December thirty-first of the previous year or such other date as the commissioner may authorize for such company, and its business of that year. The commissioner may, for cause shown, extend the filing date of the annual statement, or of schedules or exhibits which are a part of such statement or which are required by the commissioner, for not more than sixty days beyond March first or the date authorized by the Commissioner in said year.
>
> Such annual statement shall be made on a blank furnished by the commissioner under section fifteen or on an alternate form acceptable to him. Such alternate form may be the latest applicable form of annual statement approved by the National Association of Insurance Commis-

sioners appropriate to the several kinds of companies, with any additional inquiries the commissioner may require for the purpose of eliciting a complete and accurate exhibit of the condition and transactions of the companies. Such statement shall be subscribed and sworn to by the president and secretary or, in their absence, by two of its principal officers. The commissioner may at other times require any such statements as he may deem necessary.

* * *

STATEMENT OF THE CASE

Pursuant to Supreme Court Rule 22.1, the Commonwealth supplements the statement of the case made by Liberty at pages 3-5 of the petition, as follows. First, the Commonwealth incorporates the statement of facts and prior proceedings set forth in the opinion of the Mas-

sachusetts Supreme Judicial Court, Pet. App. A3-A6. Second, the Commonwealth adds the following legislative history and facts concerning the operation of the tax at issue.

The Commonwealth has imposed an excise on insurance companies doing busi- ness in the Commonwealth for over a cen- tury. See Mass. St. 1862, c. 224, §§ 1 and 2 (accident insurers); Mass. St. 1880, c. 227, § 1 (life insurers). For much of that time, the Massachusetts in- surance excise was based on total premi- ums. See Mass. St. 1943, c. 531 (chang- ing measure of the excise on life in- surers from net value of policies to total premiums).

In 1971, the Massachusetts Legisla- ture amended the existing measure

of the excise to include "gross investment income" earned during the preceding year, as reported by each domestic insurer to the Massachusetts Commissioner of Insurance in the annual statement of condition filed by each domestic company with him. See Mass. St. 1971, c. 555, § 27.

The "annual statement of condition" identified in § 22A is filed by each Massachusetts insurance company pursuant to Mass. Gen. Laws c. 175, § 25. The annual statement shows the company's "financial condition on December [31] of the previous year . . . and the company's business of that year." Id. The purpose of the form is to "elicit [ ] a complete and accurate exhibit of the condition and transactions of the companies." Id.

As the court below noted, the fact that the tax is based upon each company's annual statement results in a "tax measure which includes items that are not 'income' to the companies in the traditional sense, such as imputed home office rent, amortization of federal investment tax credits, and earnings on assets held in connection with employee and agents' pension plans; and excludes items which are income in the traditional sense, such as capital gains." Pet. App. A6.

Finally, as the Court below noted, the Massachusetts excise tax includes in its measure interest on bonds issued by both the United States and the Massachusetts governments. Id. at A8.

REASONS FOR DENYING THE PETITION

Under Supreme Court Rule 17, "[a] review on writ of certiorari is not a matter of right but of judicial discretion, and will be granted only when there are special and important reasons therefor." The purpose of certiorari jurisdiction is to permit the Court to select cases "of such gravity and general importance" as to warrant plenary review. In Re Woods, 143 U.S. 202, 206 (1892).

For the reasons set forth below, Liberty's petition does not satisfy the traditional criteria which guide the Court's discretionary review. Accordingly, the petition should be denied.

I. THE DECISION BELOW CORRECTLY APPLIES THE DECISIONS OF THIS COURT UPHOLDING FRANCHISE TAXES.

Liberty asserts a conflict between the decision below and decisions of this Court. This claim has no merit.

This Court has repeatedly held that the States can lawfully consider tax-exempt federal income in calculating a franchise tax.[1/] The Court has "consistently upheld franchise taxes measured by a yardstick which includes tax-exempt

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1/ See, e.g., Society for Savings v. Coite, 6 Wall. 594 (1868); Provident Institution for Savings v. Massachusetts, 6 Wall. 611 (1868); Home Insurance Co. v. New York, 134 U.S. 594 (1890); Flint v. Stone Tracy Co., 220 U.S. 107 (1911); Educational Films Corp. v. Ward, 282 U.S. 379 (1931); Pacific Co. v. Johnson, 285 U.S. 480 (1932); Tradesmens National Bank v. Oklahoma Tax Commission, 309 U.S. 560 (1940); Werner Machine Co. v. Director, Division of Taxation, 350 U.S. 492 (1956)(per curiam).

income or property, even though a part of the economic impact of the tax may be said to bear indirectly upon such income or property." Werner Mach. Co. v. Director of Div. of Taxation, 350 U.S. 492, 494 (1956)(per curiam).

The court below cited Werner and held that § 22A imposed a permissible franchise tax. See Pet. App. A6-A9; A35-A39. Contrary to Liberty's claim, the court below did not "pronounce[ ] that Northwestern Mutual Ins. Co. v. Wisconsin, 275 U.S. 136 (1927), has been overruled." Pet. 12, citing Pet. App. A6-A7. Rather, the court below reasoned that Northwestern Mutual must be read in light of subsequent cases that have upheld franchise taxes measured in part

by a "yardstick which includes tax-exempt income or property[.]" Werner Mach. Co., 350 U.S. at 535.

The court's reasoning echoed that expressed in its 1981 decision upholding § 22A. See Pet App. A26-A42. In its 1981 decision, the court addressed Northwestern and stated that "the fundamental issue" was "not whether the measuring base relies on gross income or net income," Pet. App. A36, but rather whether the tax evidenced those incidents and characteristics which distinguish a franchise from a property tax. Id.

In its 1989 decision, the court also correctly distinguished Northwestern on the ground that while Northwestern concerned a tax on "gross income," § 22A in operation did not, because it imposed

an excise measured by "gross investment income" as reported to the Commissioner of Insurance in the annual statement. See Pet. App. A6; Mass. Gen. Laws c. 63, § 22A, and c. 175, § 25. The court below stated that it had "carefully looked behind the labels of the State statute to determine whether the excise tax of [§ 22A] was a nondiscriminatory franchise or other nonproperty tax which is permitted under Federal law, or whether it was a property tax forbidden by Federal law." Id. The court noted, correctly, that "the tax measure of § 22A includes items that are not 'income' to the companies in the traditional sense, such as imputed home office rent, amortization of Federal investment tax credits, and earnings on assets held in connection with employee and agents'

pension plans; and excludes items which are income in the traditional sense, such as capital gains." Id. The court concluded that "the fact that the measure of the tax mentions 'gross investment income' as reported in the annual statement does not divest the tax of its excise character." Id. These excerpts from the decision below show that the court acknowledged and distinguished Northwestern; it did not suggest that the case has been "overruled."

Finally, the decision below is particularly supported by Educational Films Corporation v. Ward, 282 U.S. 379 (1931). Ward upheld the inclusion of interest on federal bonds in the measure

of a New York corporate franchise tax. The Court "look[ed] to the operation of the statute," and found that "it is plain that it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise." Id. at 388. Like the New York tax, the Massachusetts tax under § 22A "can be levied only when the corporation both seeks or exercises the privilege of doing business in one year and has been in receipt" of the specified investment income during the previous fiscal year. Id. For this reason, the Massachusetts tax cannot be said to be a tax "exclusively on income apart from the franchise." Ward, 282 U.S. at 388. Since the decision below is consistent with Educational Films Corporation v. Ward,

as well as the other decisions of this Court cited above, there is no need for plenary review.

II. LIBERTY'S CLAIM OF "CONFLICT" AND "CONFUSION" IN THE LOWER COURTS IS OVERSTATED.

The first question presented by Liberty involves the meaning of a statute, the former 31 U.S.C. § 742, not the Constitution. Questions of statutory interpretation are usually left to the lower courts to sharpen and resolve. In other cases, this Court leaves resolution of statutory questions to Congress. In any event, this Court does not normally grant review of statutory questions in the absence of a clear conflict in the

lower courts or other compelling reasons. Moreover, a conflict in the lower courts will not justify review unless it is "real and embarassing." Rice v. Sioux City Cemetary, 349 U.S. 70, 79 (1955), quoting Layne F. Bowler Corp. v. Western Well Works, Inc., 261 U.S. 387, 393 (1923) (conflicts in federal courts).

The "conflict" asserted by Liberty is neither real nor embarassing. In fact, (1) the clear majority of the lower courts have upheld taxes similar to the Massachusetts tax on domestic insurance companies, and (2) the allegedly "conflicting" decisions of other state courts are distinguishable because of material differences in the state taxes at issue.

A. The Decision Below Is Consistent With The Decisions of Other State Courts.

Liberty argues that certiorari is necessary because "conflict" and "confusion" exist in the decisions of the highest courts of several states. See Pet. 7. No such conflict exists in this case.

The overwhelming majority of state courts have consistently applied § 742 to uphold state taxes similar to § 22A on the ground that they are "franchise or other non-property taxes" exempt from the prohibition of § 742. See Pet. 16-18 and Pet. App. A7 (cases collected); see also Raymond Bag Co. v. Bowers, 126 N.E.2d 321 (Ohio 1955), app. dism., 350 U.S. 1003 (1956). This Court

has consistently denied review or dismissed appeals in these cases.

Liberty disparages these cases, which represent the great weight of precedential lower court decisions in the area, on the ground that they "have ignored the teaching of [Complete Auto Transit v. Brady, 430 U.S. 274 (1977), and American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983)] and have used outmoded tax labelling to preserve (but never to strike down) challenged state taxes." Pet. 16. This charge, even if true, would not show conflict among the lower courts. At most, the charge concerns consistency between the decisions of state courts and decisions of this Court. For the reasons in Section I, however, this charge has no

merit because the decisions of this Court support both the decision of the Massachusetts Supreme Judicial Court and the consistent decisions of a clear majority of state courts that have considered § 742.

Liberty's claim of conflict among the lower courts also relies on mischaracterizations of the state decisions. Those decisions (collected at Pet. 16-17) do not rely on "outmoded tax labelling." Pet. 16. Rather, they apply the standards set by this Court for determining whether a tax is a "franchise" that is exempted from the statutory prohibition against taxation of federal obligations. See, e.g., Centerre Bank of Crane v. Director of Revenue, 744 S.W.2d 754 (Mo. 1988), and

Savings League of Wisconsin, Ltd. v. Wisconsin Dept. of Revenue, 416 N.W.2d 650 (1987), app. dism., 109 S.Ct. 37 (1988)(both applying Werner Machine Co. v. Director, Division of Taxation, 350 U.S. 402 (1956), and Educational Film Corp. v. Ward, 282 U.S. 379 (1931)). Thus, the Massachusetts decision is only the latest in a long line of cases in which a state court has properly upheld a franchise tax and this Court has denied review. For these reasons, the decision below does not create a conflict of decision or rationale which warrants plenary review.

B. The Few Cases Striking Down State Taxes Under § 742 are Distinguishable because of Material Differences in the State Taxes At Issue.

Liberty attempts to support its claim of conflict by citing cases in which state courts have invoked § 742 to strike down state taxes. See Pet. 17-18. While six decisions are cited, only two are the controlling precedents of a state. The first of these two, a Rhode Island case, does not demonstrate a conflict worthy of review by this Court. In 1981, the Rhode Island Supreme Court struck down the application of the Rhode Island Business Corporation Tax to sale proceeds and interest from federal obligations. Federal Products Corp. v. Norberg, 429 A.2d 447, 449-50 (R.I.

1981). The court noted, however, that the Rhode Island tax was not levied under the Rhode Island "Corporate Franchise Tax." Id. Further, the Rhode Island tax bore none of the indicia of a franchise tax identified by the Massachusetts court below, such as its limitation to years in which the franchise is exercised, and its exclusion of certain traditional forms of income. See Pet. App. A6. For these reasons, the Rhode Island case did not squarely present, let alone decide, the issue Liberty presents here.

The Pennsylvania cases cited by Liberty similarly do not support the claim of national "conflict" or "confusion" in the application of § 742.

In fact, two of the three cited Pennsylvania cases solely concern state law issues, and do not construe § 742 at all. See First Federal Savings & Loan Ass'n of Philadelphia v. Commonwealth, 528 A.2d 942 (Pa. 1987); C.C. Collings & Co., Inc. v. Commonwealth, 488 A.2d 1187 (Commonwealth Ct. Pa. 1984), aff'd per curiam sub. nom. Commonwealth Securities and Investments, Inc. v. Commonwealth, 514 A.2d 1373 (Pa. 1986).

The third Pennsylvania case, Dale National Bank v. Commissioner, 465 A.2d 965 (Pa. 1983), is a straight-forward application of American Bank and Trust Co. v. Dallas County, 463 U.S. 855 (1983). Dale held that the Pennsylvania bank share tax was not a franchise tax exempted by § 742. Id. at 968. But the

Pennsylvania bank share tax - like the Dallas tax at issue in American Bank - had none of the characteristics, mentioned above, of the Massachusetts tax on domestic insurance companies at issue in this case. For this reason, Dale National Bank does not conflict with the decision below and does not support certiorari.

In sum, the "conflict" of lower court decisions alleged by Liberty is illusory. There is no current conflict of decisions and no reason to anticipate the development of a conflict among the state courts. At most, the cases reveal predictable differences in result where a statutory standard is applied to differ-

ent state taxes and factual circumstances. These differences do not support plenary review in this case.[2/]

III. THE CONTRACT CLAUSE QUESTION DOES NOT MERIT REVIEW BY THE COURT.

Liberty also seeks review of the question "whether the Contracts Clause permits a state Commissioner of Revenue to administer state statutes so as to tax bonds issued by independent state authorities, even though the state

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2/ Finally, if there is any ambiguity in § 742, that ambiguity is better resolved through legislative action than by plenary review in this Court. Clarification by Congress could include assessment of all relevant legislative concerns, including current federal and state revenues. See Pet. 5-6, 20. The Court's decision, by contrast, would be limited to an application of the 1959 amendment to § 742 to the specific terms of the Massachusetts tax on domestic insurance companies.

Legislature and the Commissioner of Revenue's predecessor have declared those bonds to be exempt." Pet. i.

Whether or not review is granted on Question No. 1, the Court should deny review of Question No. 2, because (1) the decision of the court below rests on an independent and adequate state law ground, and (2) even if Question No. 2 presents a reviewable federal question, Liberty has not shown that the question is of such general importance as to merit plenary review.

Liberty argues that this case "presents an important issue of the impairment of contracts, because the Massachusetts Commissioner of Revenue attempted to tax [certain bonds] which the Legislature and state tax commission have declared to be exempt." Pet. 20-21.

The court below determined, however, as a matter of state law, that the "exemption" from tax contained in the relevant enabling acts did not prohibit the inclusion of the interest on the state bonds in the measure of an excise tax on the bondholder. Pet. App. A8-A9.

Thus the court held that "§ 22A requires taxpayers to include in their excise tax base" the interest on the state obligations held by Liberty. Id. at A8.

The court conceded that the enabling acts of the state authorities "exempt State bonds issued by those authorities from taxation on income or property." Id. The court held, however, that the state obligations "are not exempt from forming part of the base on which an

excise tax is levied on the privilege of doing business in Massachusetts." Id. at A9 (citation omitted). Accordingly, the court held that since the tax on Liberty's franchise impaired no legislative "covenant" with Liberty to be free from taxation, there was no merit to Liberty's Contracts Clause claim. Id.

This Court lacks jurisdiction to review a state court judgment that rests on an "independent and adequate" state law ground. See Michigan v. Long, 463 U.S. 1032 (1983). Although this Court on some occasions has reviewed state court judgments and interpreted state law in deciding Contract Clause claims, (see State of Indiana ex rel. Anderson v. Brand, 303 U.S. 95, 100 (1938)), this Court has also deferred in such cases to

the state court's construction of state law, and has held that reversal would be proper only if the state decision were "manifestly wrong," and only if the relevant statute "could not have expressed the meaning thus attributed to it" by the state court. Atlantic Coast Line R.R. v. Phillips, 332 U.S. 168, 171 (1947).

Since the decision below reasonably interpreted the state enabling acts, there is no doubt as to the adequacy of the state law ground for the judgment below on Liberty's Contracts Clause claim. Furthermore, in the circumstances, the Court should also determine that there is sufficient "independence" to the state law ground to foreclose review under 28 U.S.C. § 1257.

Finally, even if Question No. 2 presented an issue within the jurisdiction of the Court, the question would not merit review by certiorari. Liberty claims that other state courts have decided similar questions concerning a state statutory exemption of state bonds from franchise taxation, and, therefore, "the second issue raised by this Petition has immediate significance for many states in addition to Massachusetts." Pet. 21 and n. 11. Liberty makes no claim, however, that the lower courts have reached inconsistent results on these questions of state law. Nor does Liberty claim a split of opinion in the lower courts on similar Contracts Clause claims. Indeed, most of the cases cited by Liberty in support of review of

Question No. 2 do not even raise Contract Clause questions.

In sum, there is no reason for plenary review of Liberty's Question No. 2 at this time.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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No. 89-593

In the Supreme Court of the United States

OCTOBER TERM, 1989

LIBERTY MUTUAL INSURANCE COMPANY, ET AL.,
PETITIONERS

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME JUDICIAL COURT OF MASSACHUSETTS

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTIONS PRESENTED

1. Whether the inclusion of interest on obligations of the United States in the measure of the tax imposed on domestic insurance companies by Mass. Gen. L. ch. 63, § 22A (1978) for the years 1971 through 1977 violated the Constitution of the United States or Rev. Stat. § 3701 (1878) (31 U.S.C. 742).

2. Whether the inclusion of interest on obligations issued by Massachusetts governmental entities and declared to be exempt from taxation under Massachusetts laws, in the measure of the tax imposed on domestic insurance companies by Mass. Gen. L. ch. 63, § 22A (1978) for the years 1971 through 1977 violated the Contracts Clause (Art. I, § 10, Cl. 1) of the Constitution of the United States.

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BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

OPINIONS BELOW

The opinion of the Supreme Judicial Court of Massachusetts (Pet. App. A1-A11) is reported at 405 Mass. 352, 541 N.E.2d 566. The opinion of the Massachusetts Appellate Tax Board (Pet. App. A12-A25) is unreported.

JURISDICTION

The judgment of the Supreme Judicial Court of Massachusetts (Pet. App. A43) was entered on July 11, 1989. The petition for a writ of certiorari was filed on October 9, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1257(a).

STATEMENT

Petitioners are insurance companies organized under the laws of Massachusetts, with their principal place of business in that Commonwealth. They were therefore subject to the tax imposed by Mass. Gen. L. ch. 63, § 22A (1978), during the years 1971 through 1977.[1] Each petitioner filed returns includ-

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[1] Until January 1, 1982, Mass. Gen. L. ch. 63, § 22A (1978) provided:

> *Domestic Insurance Companies to Pay Annual Excise.* Every domestic insurance company coming within the scope of the definition of a domestic company in section one of chapter one hundred and seventy-five shall annually pay, as part of its excise imposed under this chapter, an amount equal to one per cent of its total gross investment income earned during the preceding calendar year, as reported in its annual statement for said year filed with the commissioner of insurance and as shown in Exhibit 3 of said statement for a life insurance company or in Item 10, Column 8, Part I of the Underwriting and Investment Exhibit for any other domestic insurance company.

At the same time, Section 28 provided in relevant part:

> *Payment of Tax.* * * *. Liability for the taxes imposed by sections twenty to twenty-three, inclusive, * * * shall be incurred by reason of the transaction of business at any time within the calendar year preceding that in which the return is required to be filed.

Effective January 1, 1982, Section 22A contains an exception for life insurance companies. Petitioners are not life insurance companies.

ing the information required for assessment of the tax imposed by Section 22A for each of the years 1971 through 1977. On those returns, each included in gross investment income interest earned from bonds of the United States, Treasury Notes, and other obligations of the United States, and also interest from bonds that had been issued by Massachusetts governmental entities and that were exempted from taxation under Massachusetts law. Each paid the taxes resulting from inclusion of those interest items. Each petitioner thereafter made timely applications to the Commissioner of Revenue to abate the excise taxes for the years 1971 through 1977. Upon the Commissioner's refusal, the petitioners appealed to the Appellate Tax Board. Pet. App. A3-A4, A12-A14.

In the Appellate Tax Board proceeding, the parties submitted a Statement of Agreed Facts covering returns for each petitioner's 1975 taxable year, which they agreed was a typical year for the issues raised. Petitioners asserted that the inclusion of interest from federal obligations in gross investment income taxable under Section 22A was unconstitutional and in conflict with Rev. Stat. § 3701 (1878) (31 U.S.C. 742 [2]), and that inclusion of interest from obligations issued by certain Massachusetts governmental entities conflicted with the exemption of those obli-

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[2] As this Court pointed out in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 859 n. 1 (1983), Title 31 of the United States Code was not enacted until 1982, when it was reformulated without substantive change, and Rev. Stat. § 3701 (1878) was replaced by 31 U.S.C. 3124(a) (1982). Because the state taxes here at issue were for the years 1971 through 1977, Rev. Stat. § 3701 (1878), as amended in 1959, governs this case.

gations from taxation by the terms of the enabling Acts of those entities, and thus violated the Contracts Clause (Art. I, § 10, Cl. 1) of the Constitution of the United States. Pet. App. A14-A15.

The Appellate Tax Board denied both claims. It rejected petitioners' reliance on *Northwestern Mutual Life Ins. Co.* v. *Wisconsin*, 275 U.S. 136 (1927), as governing authority, pointing out that this Court before and since that decision has held that the Constitution and Rev. Stat. § 3701 (1878) do not prohibit the imposition of nondiscriminatory state franchise taxes measured by assets including federal obligations, or by income including interest from federal obligations. It added that the Supreme Judicial Court of Massachusetts had held that the tax imposed by Section 22A is a franchise tax, and that inclusion of interest from federal obligations in the measure of the tax imposed by Section 22A had been upheld by that court in *Commissioner of Revenue* v. *Massachusetts Mutual Life Ins. Co.*, 384 Mass. 607, 428 N.E.2d 297 (1981), which is set forth at Pet. App. A26-A42. Pet. App. A15-A18.

On similar grounds, the Appellate Tax Board rejected the claim that inclusion of interest from tax-exempt bonds of state agencies in the measure of the tax imposed by Section 22A violated the Contracts Clause of the Constitution, invoking the decision of the Supreme Judicial Court in *Massachusetts Mutual Life*, and this Court's decision in *Pacific Co.* v. *Johnson*, 285 U.S. 480 (1932). Pet. App. A19-A21.

On appeal from the Board's decision, the Supreme Judicial Court transferred the cases to itself on its own motion, and affirmed. It reviewed and reaffirmed its earlier decision in *Massachusetts Mutual Life*, pointing out that "[t]he tax imposed by § 22A is a 'nondiscriminatory franchise tax or other non-

property tax' permitted by [Rev. Stat. § 3701 (1878)]." Pet. App. A5. It rejected the authority of *Northwestern Mutual Life Ins. Co.* v. *Wisconsin*, 275 U.S. 136 (1927), on which petitioners relied and continue to rely, in favor of the later decision of this Court in *Werner Mach. Co.* v. *Director, Div. of Taxation*, 350 U.S. 492 (1956) and the whole course of this Court's decisions on intergovernmental immunities since the 1930's, noting the concurrence of other state courts and the fact that the state court decisions invoked by petitioners did not compel the opposite conclusion. Pet. App. A6-A7 & n. 7. The court also rejected petitioners' Contracts Clause claim, pointing out that it had held in *Massachusetts Mutual Life* that although the enabling Acts of certain state authorities exempted bonds issued by those authorities from taxation on income or property, those obligations were not exempted from forming part of the base on which an excise tax may be levied for the privilege of doing business in Massachusetts. Pet. App. A8-A9.

DISCUSSION

Petitioners invoke both the Constitution itself and the terms of Rev. Stat. § 3701 (1878) in support of their claim that interest on obligations of the United States and interest on statutorily tax-exempt obligations of Massachusetts governmental authorities may not be included in the measure of the tax imposed on domestic insurance companies by Section 22A of Chapter 63 of the Massachusetts General Laws (1978). We believe that neither claim has substance.

1. This Court in *Weston* v. *Charleston*, 27 U.S. (2 Pet.) 449 (1829), held that a tax on specified forms of property in the City of Charleston could not be imposed upon obligations of the United States,

since the tax would impinge upon the constitutional authority of the United States to borrow money, and would constitute "a burden on the operation of government." *Id.* at 468. That decision was followed in two cases holding that a New York tax upon the capital of state banks could be enforced only insofar as the amount on which the tax was computed was reduced by the value of United States obligations held by the banks. *Bank of Commerce* v. *New York City*, 67 U.S. (2 Black) 620 (1863); *Bank Tax Case*, 69 U.S. (2 Wall.) 200 (1865).

From 1862 through 1870, Congress passed seven statutes authorizing the Secretary of the Treasury to borrow large amounts on the credit of the United States. In slightly variant terms, each statute provided that obligations of the United States generally, or the obligations authorized by that statute, should be exempt from taxation by state or local authority.[3] The statutory exemption was thereafter made general, and permanent, by Section 3701 of the Revised Statutes (1878):

> All stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority.

Meanwhile, this Court had held that certain taxing statutes of Connecticut and Massachusetts were franchise taxes, *i.e.* imposed for the privilege of doing business in the State, and that such taxes were not on, but could be measured by, corporate assets, including obligations of the United States. *Society for Savings* v. *Coite*, 73 U.S. (6 Wall.) 594 (1868);

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[3] The statutes are listed, and the exempting provisions quoted, in *Smith* v. *Davis*, 323 U.S. 111, 117 n. 7 (1944).

Provident Institution v. *Massachusetts*, 73 U.S. (6 Wall.) 611 (1868); *Hamilton Co.* v. *Massachusetts*, 73 U.S. (6 Wall.) 632 (1868). Significantly, the 1862 Massachusetts tax held to be a franchise tax in *Provident Institution* v. *Massachusetts*, *supra*, was the origin of the present excise tax on domestic insurance companies, although the measure of the tax has been amended from time to time. See *Commissioner of Insurance* v. *Commonwealth Mutual Liability Ins. Co.*, 308 Mass. 385, 386, 388, 32 N.E.2d 231, 233 (1941).

Since the 1868 decisions, state franchise taxes on corporations, measured either by the property of the corporation or by its income, have consistently been permitted to include in their taxable measure obligations of the United States or income from such obligations or other exempt sources. *Home Insurance Co.* v. *New York*, 134 U.S. 594 (1890); *Educational Films Corp.* v. *Ward*, 282 U.S. 379 (1931); *Tradesmens Nat'l Bank* v. *Oklahoma Tax Commission*, 309 U.S. 560 (1940); *Werner Mach. Co.* v. *Director, Div. of Taxation*, 350 U.S. 492 (1956).[4] In the reciprocal situation, this Court upheld a federal tax on doing business in corporate form measured by net income that included interest on municipal bonds. *Flint* v. *Stone Tracy Co.*, 220 U.S. 107 (1911). Although this Court has recently referred to the distinction between a tax on, and a tax measured by, federal obligations as "formal but economically

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[4] *Macallen Co.* v. *Massachusetts*, 279 U.S. 620 (1929), once thought to cast doubt on these decisions, and invoked by petitioners at Pet. 7, 22, 25, has been said by this Court to be without precedential value. *Phillips Chemical Co.* v. *Dumas Ind. School Dist.*, 361 U.S. 376, 382 (1960); *United States* v. *City of Detroit*, 355 U.S. 466, 472 n. 2 (1958).

meaningless," it at the same time quoted from an earlier decision stating that the distinction is "firmly embedded in the law." *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855, 858 (1983) (quoting *Society for Savings* v. *Bowers*, 349 U.S. 143, 148 (1955)).

In any event, however the distinction may be described, Congress perpetuated it by the Act of Sept. 22, 1959, Pub. L. No. 86-346, § 105(a), 73 Stat. 622, when it amended Rev. Stat. § 3701 (1878) by adding a second sentence, as follows:

> This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

There can be no substantial doubt that Section 22A is a "nondiscriminatory franchise tax[] * * * imposed on corporations." It is clearly nondiscriminatory, and petitioners do not contend otherwise. Cf. *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392 (1983). While, as this Court stated in *Werner Mach. Co.* v. *Director, Div. of Taxation*, 350 U.S. at 493, the characterization of the court below is not conclusive, this Court in *Provident Institution* v. *Massachusetts*, *supra*, found the predecessor of the present statute to be a franchise tax. Section 28 of Chapter 63, set forth in footnote 1, *supra*, provides that "[l]iability * * * shall be incurred by reason of the transaction of business". And the Massachusetts Supreme Judicial Court has given substantive meaning to the fact that the tax is a franchise tax by hold-

ing that after a corporation has been enjoined from doing business, it is no longer subject to the excise imposed by Sections 22-29 of Chapter 63 of the General Laws of Massachusetts. *Commissioner of Insurance* v. *Commonwealth Mutual Liability Ins. Co., supra.*

Against this authority, petitioners invoke this Court's decision in *Northwestern Mutual Ins. Co.* v. *Wisconsin*, 275 U.S. 136 (1927), which they state (Pet. 6) has never been overruled or impaired. The Court in that case held that a three percent license fee for transacting business in the state (*i.e.*, a franchise tax), measured by gross income, was unconstitutional insofar as interest on bonds of the United States was included. The Court invoked *Gillespie* v. *Oklahoma*, 257 U.S. 501 (1922), and stressed a difference between gross income and net income, although at the time, when the decision in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U.S. 429 (1895), as well as the reciprocal position, was unquestioned, a state tax on net income from government bonds was no less unconstitutional than a tax on gross income from the same source. The Court, in any event, did not hold that the tax was not a franchise tax, but only that the measure offended the Constitution insofar as it included interest from obligations of the United States.

Even if the *Northwestern* decision retained, until 1959, the authority attributed to it by petitioners, there is no reason to believe that it was not legislatively overruled by the amendment to Rev. Stat. § 3701 (1878), which explicitly excepted nondiscriminatory franchise taxes from the immunities ordered by that statute. Nor is there any basis for petitioners' suggestion that a tax measured by gross income

can not be a franchise tax. See *General Motors Corp.* v. *Washington*, 377 U.S. 436 (1964) (upholding state franchise tax based on "gross wholesale sales of motor vehicles, parts and accessories delivered in the State" against constitutional challenges based on Commerce and Due Process Clauses); *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274 (1977) (upholding state franchise tax based on gross income against Commerce Clause challenge). And amended Rev. Stat. § 3701 (1878) makes no distinction between taxes measured by gross or net income; it simply permits nondiscriminatory franchise taxes.

It seems clear, in any event, that although it may not have been explicitly overruled, the *Northwestern* decision did not long retain authority. *Gillespie* v. *Oklahoma*, *supra*, which it invoked as authority, was overruled by *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 367 (1938). *Mountain Producers* also overruled *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. 393 (1932), which had relied on *Northwestern*. Indeed, a number of the cases that succeeded *Northwestern* and invoked its authority were later explicitly overruled.[5]

More importantly, as noted in *United States* v. *New Mexico*, 455 U.S. 720, 731 (1982), the Court, with the decision in *James* v. *Dravo Contracting Co.*, 302 U.S. 134 (1937), "marked a major change in course". The new course, set forth in *United States* v. *New Mexico* (455 U.S. at 733-738), is summarized in *South Carolina* v. *Baker*, 108 S. Ct. 1355, 1366 (1988):

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[5] *E.g.*, *Long* v. *Rockwood*, 277 U.S. 142, 148 (1928), overruled in *Fox Film Corp.* v. *Doyal*, 286 U.S. 123 (1932); *Panhandle Oil Co.* v. *Knox*, 277 U.S. 218, 221 (1928), overruled in *Alabama* v. *King & Boozer*, 314 U.S. 1 (1941).

> In sum, then, under current intergovernmental tax immunity doctrine the State can never tax the United States directly but can tax any private parties with whom it does business, even though the financial burden falls on the United States, as long as the tax does not discriminate against the United States or those with whom it deals. See *Washington* [v. *United States*], 460 U.S. [536,] 540 [(1983)]; [*United States* v.] *County of Fresno*, 429 U.S. [452,] 460-463 [1977]; [*United States* v.] *City of Detroit*, 355 U.S. [466,] 473 [1958]; *Oklahoma Tax Comm'n* [v. *Texas Co.*], 336 U.S. [342,] 359-364 [1949]. A tax is considered to be directly on the Federal Government only "when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities." *New Mexico*, *supra*, 455 U.S. at 735.

Accordingly, under current doctrine it is clear that the Constitution does not itself immunize interest on obligations of the United States held in private hands from taxation by the States, and *a fortiori* does not immunize such interest from being included in the measure of a franchise tax. Of course, Congress may establish and define immunity for federal instrumentalities (*Carson* v. *Roane-Anderson Co.*, 342 U.S. 232 (1952); *First Agricultural Nat'l Bank* v. *State Tax Commission*, 392 U.S. 339 (1968)), as it has done in Rev. Stat. § 3701 (1878), but there is no constitutional reason to diminish the scope of the exception for nondiscriminatory franchise taxes that Congress has explicitly provided.

The court below correctly stated (Pet. App. A7 n. 7) that there is no conflict in the decisions of authoritative state courts on the intergovernmental immunity question. *First Federal Savings & Loan Ass'n* v. *Commonwealth*, 515 Pa. 369, 528 A.2d 942 (1987) and *Commonwealth Securities and Investment Inc.* v. *Commonwealth*, 511 Pa. 376, 514 A.2d 1373 (1986) (cited at Pet. 17, 18, 21) involved purely state questions under state statutes. Cf. *Continental Bank* v. *Arizona Department of Revenue*, 131 Ariz. 6, 638 P.2d 228 (1981) (cited at Pet. 6, 13, (state question under state constitution)). *Dale Nat'l Bank* v. *Commonwealth*, 502 Pa. 170, 465 A.2d 965 (1983) (cited at Pet. 17) followed *American Bank & Trust Co.* v. *Dallas County*, 463 U.S. 855 (1983) with respect to a property tax. In *Federal Products Corp.* v. *Norberg*, 429 A.2d 447 (R.I. 1981) (cited at Pet. 17) although the interest from federal obligations was not included in income taxed under the Rhode Island statute, those obligations were employed in computing that part of corporate income that was apportioned to Rhode Island, and thus the case fell within the specific prohibition of Rev. Stat. § 3701 (1878), as amended in 1959.[6] The first question presented by petitioners accordingly does not merit further review.

2. Petitioners' gross investment income during the years here at issue also included interest on bonds of Massachusetts governmental entities authorized and issued under state statutes providing that such bonds should be exempt from taxation. Petitioners assert that including the interest on such bonds in the measure of the tax imposed by Section 22A impairs

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[6] None of the other state decisions cited by petitioners is relevant to the issues raised in the petition.

the obligation of contract in violation of Article I, Section 10, Clause 1 of the Constitution of the United States. The Appellate Tax Board (Pet. App. A19-A21) and the Supreme Judicial Court (Pet. App. A9) correctly rejected that claim.

As this Court recently pointed out (*United States* v. *Wells Fargo Bank*, 108 S. Ct. 1179, 1182 (1988)):

> [A]n exemption of property from all taxation had an understood meaning: the property was exempt from *direct* taxation, but certain privileges of ownership such as the right to transfer the property could be taxed. Underlying this doctrine is the distinction between an excise tax, which is levied upon the use or transfer of property even though it might be measured by the property's value, and a tax levied upon the property itself. The former has historically been permitted even where the latter has been constitutionally or statutorily forbidden.

Accordingly, this Court, as long ago as *Orr* v. *Gilman*, 183 U.S. 278 (1902), held that a state inheritance tax applicable to state bonds issued with statutory provisions for exemption from taxation did not impair the obligation of contract in violation of the Constitution. The claim asserted by petitioners in this case was expressly rejected by this Court in *Pacific Co.* v. *Johnson*, 285 U.S. 480 (1932). In that case, the Court held that income from bonds issued by California municipalities and declared to be exempt from taxation by the state constitution, could nevertheless be included in the measure of a corporate franchise tax subsequently imposed by California without impairing the obligation of contract in violation of the Constitution. No case has since ques-

tioned the authority of that decision, which marked the Court's turning away from *Macallen Co.* v. *Massachusetts*, 279 U.S. 620 (1929), and other cases invoked by petitioners. See *Tradesmens Nat'l Bank* v. *Oklahoma Tax Commission*, 309 U.S. 560, 565-566 (1940); *United States* v. *City of Detroit*, 355 U.S. 466, 471 (1958).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Supreme Court of the United States

October Term, 1989

LIBERTY MUTUAL INSURANCE COMPANY, and
LIBERTY MUTUAL FIRE INSURANCE COMPANY,

Petitioners,

v.

COMMISSIONER OF REVENUE,
COMMONWEALTH OF MASSACHUSETTS,

Respondent.

On Petition For Writ Of Certiorari
To The Supreme Judicial Court Of Massachusetts

SUPPLEMENTAL BRIEF OF PETITIONERS IN REPLY TO THE BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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Petitioners Liberty Mutual Insurance Company and Liberty Mutual Fire Insurance Company (jointly, "Liberty Mutual") submit this Supplemental Brief pursuant to Rule 22.6. This Supplemental Brief replies to the Brief for the United States As Amicus Curiae ("U.S. Brief"), which was filed March 2, 1990, and supports Liberty Mutual's Petition for Writ of Certiorari ("Petition"), which was filed October 9, 1989. It is respectfully submitted that the U.S. Brief largely ignores the clear intent of Congress and the express language of the governing federal statute, and addresses the merits of the case rather than the appropriateness of granting certiorari.

INTRODUCTION

In our petition for certiorari we argued that Mass. G.L. c. 63, § 22A, is in direct violation of 31 U.S.C. § 742. That provision exempts all obligations of the United States from "every form" of state taxation, "direct or indirect." The Massachusetts law, by including the interest on federal obligations in the tax it levies on domestic insurance companies,[1] violates the federal statute. The purpose of the federal statute, and its violation here by the state statute, would be quite clear but for the exception in 31 U.S.C. § 742 allowing states to impose "nondiscriminatory franchise . . . taxes . . . ."

Our contention is simply that this exception must leave some independent force to the requirement that the permitted tax be in reality a franchise tax, and that whether the state has properly given effect to this limitation on its taxing power presents a substantial federal question not likely to be fairly considered other than by periodic review by this Court. The Solicitor General, we respectfully suggest, has largely missed the point of our submission.

The Solicitor General recounts the progressive disenchantment of this Court with the constitutional doctrine of intergovernmental tax immunity, a story having its denouement in this Court's decision in *South Carolina v. Baker*, 485

[1] Indeed in the usual case under this statute bond interest will be the principal item so taxed.

U.S. 505 (1988). But that story has nothing to do with this case. The immunity which petitioners urge, and on which they and other investors relied in purchasing United States obligations, is one mandated by Congress and reenacted, broadened and clarified as recently as 1959. It is not some archaic constitutional doctrine which we seek to resurrect. Rather, we ask fidelity to the expressed and recent will of Congress.

The Solicitor General joins the Commonwealth in asserting as a principal basis for calling this a true "franchise" tax (a tax on the privilege of doing business) the doubtful proposition that this tax is not levied in any year in which the company is not doing business. But unless the protection of the statute is to be rendered a nullity by a mere affixing of labels by the state courts, more than this must be shown. In effect both the Commonwealth and the Solicitor General read the term "franchise" out of the statute, leaving only the requirement that the tax on United States obligations be nondiscriminatory. Perhaps such a recasting would accord with what the Solicitor General considers more modern principles of intergovernmental tax relations. It is certainly not faithful to the command of Congress.

Like the thirteenth chime of the clock, the Solicitor General's reference to this Court's decision in *Provident Institution v. Massachusetts*, 73 U.S. (6 Wall.) 611 (1868), betrays the basically dismissive attitude of the U.S. Brief to the substantial issues raised here. The Solicitor General argues (U.S. Brief at 7) that the tax upheld in *Provident* was a franchise tax and "the origin of the present excise tax on domestic insurance companies. . . ." The characterization is inaccurate and the analogy non-existent. *Provident* involved a tax on the deposits of savings institutions and reached the perfectly sensible conclusion that the bank could not escape a part of such a tax by investing some of those deposits in federal obligations. There is no connection and no analogy with the gross investment income tax adopted in 1971.

Finally, the Solicitor General urges denial of the writ on the ground that there is no conflict in the decisions, but does not advert to our argument that these cases can only originate in state courts and come to a federal court for review by way of certiorari, and that it is not likely that any state court will take any but the most grudging view of its duties to recognize exemptions from taxation under the Congressional mandate. Thus, it is important for this Court to construe the exemption in question and give it some meaning.

A. Whether A State Tax Qualifies As A "Franchise" Tax Within The Meaning Of 31 U.S.C. § 742 Is A Federal Question.

This case turns on the construction of a federal statute enacted in order to protect federal bonds from state taxation.[2] Congress has provided that the income from federal bonds is exempt from state taxes, except in the case of a non-discriminatory "franchise" tax. This Petition presents the important question of what constitutes a "franchise" tax within the meaning of the statute. This is necessarily a federal question.

B. Section 742 Must Be Construed So As To Give Some Content To The Statutory Phrase "Franchise" Tax.

Congress must have meant the term "franchise" tax to have some realistic meaning when it used the term in 31 U.S.C. § 742, or else Congress would have permitted *any* non-discriminatory non-property tax to be imposed on a corporation. The very purpose of the 1959 amendment to Section 742 was to reduce the scope of permissible state taxes. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983). To allow the states to call any tax a franchise tax in order to save it, as the Supreme Judicial Court did here, is to allow the statutory exception to swallow the statutory rule.

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[2] Petitioners will continue to refer to the statute at issue as 31 U.S.C. § 742, as it stood during the years in question. The statute has now been recodified without substantive change as 31 U.S.C. § 3124(a).

This franchise exception can be kept within appropriate limits by confining it to its normal and accepted meaning. A "franchise" tax is one that reasonably attempts to measure the value of the franchise. Various formulas such as net worth, the value of assets, the market value of a company's stock, net income, or allocated net value of insurance in force, might reasonably be employed to approximate the value of a franchise.

The U.S. Brief maintains that Section 22A is a "franchise" tax because a Massachusetts insurance company is no longer subject to the tax once it ceases doing business in the Commonwealth. U.S. Brief at 8-9.[3] This is a necessary condition for qualifying as a "franchise" tax, but it is hardly sufficient, especially since a domestic company that ceases doing business is not likely to have much income or other benefit from its unexercised franchise anyway. On the argument of the United States the way the tax is measured would be wholly irrelevant, and a non-discriminatory tax of any kind could qualify as a "franchise" tax so long as it was labelled a tax imposed on the privilege of doing business.

The U.S. Brief entirely misses the significance of Congress' amendment of 31 U.S.C. § 742 in 1959. Congress acted in order to reject the very argument the Solicitor General now makes, as this Court explained in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 865-67 (1983). Idaho had asserted that its personal income tax could include interest on United States Government Bonds because the tax was not "on" income but rather was "on" individuals and merely "measured by" income. Congress rejected that position by providing that the exemption for United States Government Bonds "extends to *every* form of taxation that would

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[3] The U.S. Brief at 8-9 fails to reflect the fact that the Massachusetts legislature soon overruled *Commissioner of Ins. v. Commonwealth Mutual Liability Ins. Co.*, 308 Mass. 385, 32 N.E.2d 231 (1941). *See* St. 1945, c. 342, amending General Laws, c. 63, § 28.

require that either the obligations or the interest thereon, or both, be *considered, directly or indirectly*, in the computation of the tax. . . ." *See American Bank*, 463 U.S. at 867 (emphasis added).

Congress thus rejected the distinction, which is a necessary underpinning of the asserted validity of the Massachusetts tax, between a tax "on" income and a tax "measured by" income. To be sure, as the U.S. Brief says at 7-8, a *1955* decision of this Court found the distinction "firmly embedded in [judge-made] law". *Society for Savings v. Bowers*, 349 U.S. 143, 148 (1955). Far from perpetuating that distinction, however, Congress in *1959* "rejected and set aside" the Court's earlier "formalistic approach" in order to broaden the statutory prohibition. *American Bank*, 463 U.S. at 862-65.

Contrary to the Solicitor General's premise, this Petition does not ask the Court to revive the doctrine of implied intergovernmental immunity. Because Congress took express action in 1959 to define the position of the federal government – and to reject the then-prevailing view of this Court – the case is not about *implied* immunity at all.[4] Rather, Petitioners ask the Court to provide an authoritative construction of an important Act of Congress which otherwise the states have been and are free to ignore or distort.

C. The Tax At Issue Is Not A "Franchise" Tax, Because It Bears No Reasonable Relation To The Value Of The Franchise.

Since the term "franchise" tax must have some reasonable meaning, some lines must be drawn to effectuate the Congressional intent to limit the state taxes that qualify, although Congress no doubt intended to leave the states considerable latitude in determining the parameters of a permissible franchise tax. This Court established one necessary

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[4] For this reason, the U.S. Brief's citations at 10-11 to *South Carolina v. Baker*, 485 U.S. 505 (1988), and *United States v. New Mexico*, 455 U.S. 720 (1982), are not on point.

limit in *Northwestern Mutual Ins. Co. v. Wisconsin*, 275 U.S. 136 (1927). *Northwestern Mutual* held squarely that a *gross* income tax may not reach the interest on United States Government Bonds. The Court reasoned that a gross income tax measures nothing but the income from the bonds; thus it cannot be said that such a tax is imposed "on" anything else. The Court distinguished a net income tax, which takes into account expenses and other factors and bears a direct relation to value. As demonstrated in the Petition at 12-13, this Court has *never* allowed a tax measured by *gross* income to reach federal bond interest. The cases cited by the United States concern net income, net worth or the value of assets, all of which are traditional measures of franchise taxes. *Compare* Petition at 12-13 *with* U.S. Brief at 7.[5]

The tax at issue is measured by 1% of a Massachusetts insurance company's gross investment income. Gross income, however, cannot measure the value of a franchise. A taxpayer which is losing and is likely to continue to lose substantial amounts of money – and thus has a currently valueless franchise – is still required to pay a tax, possibly quite large. Two taxpayers holding equally valuable franchises may well pay very different amounts of tax. An insurer with large policy losses would be required to pay as large a gross investment income tax as an insurer with the same gross investment income but large policy surpluses.

Section 22A thus makes no attempt to measure the value of any franchise. It requires a domestic insurance company to pay 1% of the "gross investment income" it reports on its Annual Statement to the state Insurance Commissioner, regardless of every other fact of the insurer's financial condition, so long as it has not surrendered its license (or even if it

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[5] The United States cites two cases for the proposition that a gross income tax may be a franchise tax. U.S. Brief at 10, *citing General Motors Corp. v. Washington*, 377 U.S. 436 (1964); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Neither of these cases construed 31 U.S.C. § 742 at all. Both cases considered constitutional challenges only. The Court had no occasion to consider whether the tax at issue was a "franchise" tax as Congress used that term in Section 742.

has, see n. 3, *supra*). The Annual Statement was never intended to determine the value of the franchise. (It existed before Section 22A was enacted, and was picked as the basis of the tax for reasons of convenience.) The regulatory purpose of the Annual Statement is to disclose on a consistent basis[6] the financial strength of the state's insurance companies, so that a consumer, *i.e.*, a prospective buyer of a policy, not of stock in the insurer, may make an informed choice. *See* Brief in Opposition at 7. Thus the tax imposed by Section 22A is completely arbitrary in its relation to the value of each insurer's franchise. It cannot fairly be said to be imposed on the privilege of doing business and measured by the value of that privilege, even very roughly.

Long before Section 22A was enacted Massachusetts had, and still has, insurance company excise taxes based on premiums, G.L. c. 63, §§ 20, 22, and (for life insurance companies, in some circumstances) on net value of policies, St. 1943, c. 531. *See State Tax Comm'n v. John Hancock Mutual Life Ins. Co.*, 341 Mass. 555, 170 N.E.2d 711 (1960). In contrast, Section 22A was not an attempt to tax the value of the privilege of doing business, but merely to identify and tax an item of revenue that had not previously been taxed. It is an exercise in arbitrary labelling to call this tax a "franchise" tax in order to save it, when its scope and effect resulted merely from the legislature's realization that it could reach a convenient item that had hitherto escaped taxation.

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[6] It is for the sake of this consistency that the Annual Statement shows figures for imputed home office rent, to facilitate comparisons between companies that own and companies that rent their home offices. Like amortization of federal tax credits and earnings on assets earmarked for employees' and agents' pension plans, which also appear on the Annual Statement and are swept up into the tax imposed by Section 22A, these items bear no relation whatsoever to the value of the franchise.

D. The United States Is In Error Concerning The Origin Of The Massachusetts Tax At Issue.

The Solicitor General erroneously states that the predecessor of Section 22A was found to be a franchise tax in *Provident Institution v. Massachusetts*, 73 U.S. (6 Wall.) 611 (1868). U.S. Brief at 8. In fact, Section 22A was enacted for the first time in 1971, and it had no predecessor. *See* Brief in Opposition at 6; Mass. St. 1971, c. 555, § 27. The tax in *Provident* was levied on savings banks and was measured by their deposits. Section 22A, which taxes gross investment income, is an entirely different tax.

The United States' citation to *Provident* is even further afield. The bank in *Provident* argued that its deposits should be immune from taxation to the extent that they were invested in federal bonds. The Court rejected that argument, for the obvious reason that the tax was imposed on the deposits, *i.e.*, liabilities, not the bonds, *i.e.*, assets. In the parlance of the current federal statute, the tax in *Provident* did not even indirectly consider federal bonds in the computation of the tax. The issue here, where the tax is computed by measuring the income from federal bonds and other investments, is vastly different. The contention of the United States that the *Provident* case provides guidance or authority in the present situation is indicative of the Solicitor General's basically dismissive approach to the questions before the Court.

E. The United States Does Not Address The Importance Of The Questions Presented By This Petition.

Cases which challenge the application of state taxes to United States Government Bonds arise exclusively in the state courts. *See* 28 U.S.C. § 1341. The federal interest in exempting United States Government Bonds understandably appears distant to these courts, while the state interest in preserving tax revenues is immediate. Thus state courts have generally upheld state taxes in cases such as this, and have not been sensitive to the intent of Congress. This strong tendency explains why there are few conflicting decisions in the state courts. The conflict here is not among the states so much as it

is between the states on one side and the federal legislation on the other.[7] The Supreme Court is the only court able to declare authoritatively what Congress meant when it created the "franchise tax" exception to § 742.

Liberty Mutual's Petition presents an important question of statutory interpretation. The answer is likely to affect many millions of dollars of interest expense to the United States Treasury. Even if the Solicitor General is not interested in these financial implications for the federal fisc, the expectations of investors who purchased United States Government Bonds in reliance on this explicit statutory exemption are entitled to the protection Congress intends to give them. Congress has expressly acted to protect federal obligations from state taxation, thereby reducing the interest expense to the United States Treasury. The Massachusetts decision below, like other state decisions, is inconsistent with the express purpose of that legislation. The aid of the Supreme Court is required to declare and to enforce the will of Congress in protecting the federal fisc, and in any event to clarify the rules which the states must follow, whether or not the Court ultimately adopts the position Liberty Mutual asserts.

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[7] It is not clear, however, why the United States discounts *Federal Products Corp. v. Norberg*, 429 A.2d 447 (R.I. 1981). U.S. Brief at 12. To be sure, the court in that case ruled that the tax at issue was not a franchise tax, because it was enacted under the heading "Income Tax", while a separate provision carried the heading "Franchise Tax". To rely solely on this distinction, however, would be to resort to mere labelling.

CONCLUSION

The questions presented are important and unsettled. They are clearly presented by this case. The petition for certiorari should be granted.

Respectfully submitted,

Liberty Mutual Insurance Company
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March 8, 1990

89-594

No.

Supreme Court, U.S.
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In The
Supreme Court of the United States
October Term, 1989

CLIFT C. LANE and DOROTHY P. LANE,

Petitioners,

v.

JOHN E. PETERSON, JR., WALTER W. MINGER, and EDWARD H. COVELL,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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24pp

QUESTIONS PRESENTED

1. In a diversity case, does the District Court's failure to apply state law regarding the burden of proof and presumption of fraud, as they pertain to self-dealing by a fiduciary, divest the District Court of subject matter jurisdiction rendering its judgement void within the meaning of Rule 60 (b) (4) of the Federal Rules of Civil Procedure?

2. Does the District Court's failure to apply Arkansas law constitute extraordinary circumstances entitling Petitioners to relief from the District Court's judgment pursuant to Rule 60 (b)(6)?

LIST OF PARTIES

Respondents are included in this Petition, as they were in the courts below, both as individuals and in their capacity as members of a Special Panel created under a Consolidated Plan of Reorganization confirmed by the United States Bankruptcy Court for the Middle District of North Carloina, Greensboro Division; and as trustees and beneficiaries U/D/C dated July 22. 1985.

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In The
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CLIFT C. LANE and DOROTHY P. LANE,
Petitioners,

v.

JOHN E. PETERSON, JR., WALTER W. MINGER, and EDWARD H. COVELL,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioners, Clift C. Lane and Dorothy P. Lane, respectfully pray that a writ of certiorari issue to review the judgement and opinion of the United States Court of Appeals for the Eighth Circuit, entered in the above-entitiled proceeding on July 17, 1989.

OPINIONS BELOW

The *per curiam* opinion of the Court of Appeals will not be reported; the opinion is reprinted in the Appendix at p. 1a.

The Order and Supplemental Order of the District Court for the Western District of Arkansas, Texarkana Division, No. 86-4069 (Harris, J.) were not reported; the Order and Supplemental Order are reprinted in the Appendix at 4a and 7a, respectively.

JURISDICTION

Petitioners moved pursuant to Rule 60(b)(4) and (6) to vacate a final judgment entered by the District Court and affirmed by the Court of Appeals. Jurisdiction in the District Court was based upon 28 U.S.C. §1332, diversity of citizenship. On January 18, 1989, the District Court denied Petitioners' motion. On March 6, 1989, the District Court imposed sanctions upon Petitioners and their counsel for filing the motion to vacate.

On Petitioners' appeal, the Eighth Circuit affirmed the District Court's Order and Supplemental Order on July 17, 1989.

STATUTE INVOLVED

Judiciary Act of 1789, Section 54
28 U.S.C. §1652 (1982). *State laws as rules of decision.*

The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States in cases where they apply.

Rule 60(b):

On motion and upon such terms as are just, the court may relieve a party or a party's legal representative from a final judgment, order, or proceeding for the following reasons: . . . (4) the judgment is void; . . . (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, . . .

STATEMENT OF THE CASE

Petitioners (the "Lanes") founded and developed their chicken business over more than thirty-five years from a small, one-truck operation to the nation's sixth largest poultry producer. They owned the entire business either directly or indirectly through their ownership of the stock of nineteen operating companies (the "Lane companies").

In 1982, the Lanes, personally, and each of the Lane Companies, petitioned for reorganization under the Bankruptcy Code of 1978. Shortly thereafter, the Bankruptcy Court appointed Respondent Peterson its Examiner; Peterson served as Examiner at least through March, 1987. The Bankruptcy Court confirmed a consolidated plan of reorganization (the "Plan") in 1984. Section 7.05 of the Plan created a Special Panel "to aid in the operation of the business of Lane in the post-confirmation era both for the benefit of Lane and Creditors" (Plan, Disclosure Statement, p. 20, 1984). The Lanes, with the approval of the Bankruptcy Court and the Creditors, selected Peterson, the Bankruptcy Court Examiner, and Respondents Minger and Covell to serve on the Special Panel.

Under the Plan, the Special Panel was obligated to temporarily assume management of the Lane Companies if an Event of Default was not timely cured. The Creditors noticed several Events of Default in May and June of 1985. Unless cured, the Special Panel would have assumed management of the Lane Companies about August 1, 1985. By mid-June, it appeared unlikely that the defaults would be cured.

To preserve their equity in the business, the Lanes decided to sell the Lane Companies and repay Creditors. The Lanes advised the Creditors and the Special Panel on June 19, 1985 of their decision to sell the Lane Companies. On June 24, 1985, Minger received an offer from Tyson Foods, Inc. to purchase the Lane companies after the Special Panel assumed control. The members of the Special Panel discussed the offer among themselves, but did not disclose the offer to the Lanes. The Lanes first learned of Tyson's offer after the Respondents sold the Lane Companies to Tyson for thirty-five million dollars in April, 1986.

In order to concentrate their efforts on the sale of the Lane Companies, the Lanes agreed to permit the Special Panel to assume management of the Lane Companies on July 22, 1985, approximately ten days before the Special Panel was obligated to do so under the Plan. The Special Panel demanded, as a condition of assuming control early, that the Lanes transfer their stock in the Lane Companies to a trust (the "Trust") with the Special Panel members as trustees. The Lanes believed that they were the beneficiaries of the Trust. The Special Panel refused to give the Lanes a copy of the trust declaration and did not disclose to the Lanes that the members of the Special Panel were the settlors and, through the exercise of Respondents' unfettered discretion, the sole beneficiaries as well as trustees of the Trust. Accordingly, in good faith reliance upon their counsel and the Special Panel, the Lanes consented to transfer the Stock to the Trust. The transaction was consummated on July 22, 1985. At the closing, the Lanes endorsed stock certificates to the Special Panel as trustees under the Trust. There was no

document ever presented to or executed by the Lanes conveying any beneficial interest in their stock of the Lane Companies.

The Lanes first learned of the Special Panel's beneficial interest in the stock of the Lane Companies when they commenced an action against Respondents in May, 1986. After a trial on the merits, the District Court entered judgment for the Special Panel holding that the Lanes "have failed to sustain their burden of proof on each count of their complaint" *Lane v. Peterson,* No. 86-4069, p. 27 (W.D. Ark. July 2, 1987). The decision was appealed to the Eighth Circuit Court of Appeals which affirmed the District Court, *Lane v. Peterson,* 851 F. 2d 193 (8th Cir. 1988). Plaintiffs did not petition the Supreme Court for a writ of certiorari.

In December, 1988, the Lanes, through newly retained counsel, moved pursuant to Rule 60(b), to vacate the judgment entered by the District Court on July 2, 1987 because the court failed to ascertain and apply state law regarding self-dealing by a fiduciary as required in deciding diversity cases. Without addressing the Lanes' substantive basis for relief, the District Court denied the motion as being untimely. Shortly thereafter, the court granted Respondents' motion to impose sanctions upon the Lanes and their new counsel under Rule 11. In a *per cruiam* opinion filed July 17, 1989, the Court of Appeals, also without addressing the substantive basis for relief, affirmed the District Court's decision.

REASONS FOR GRANTING WRIT

I. Under *Erie,* federal courts have subject matter jurisdiction to decide diversity cases only in accordance with state substantive law; failure to apply state law conflicts with the Judiciary Act of 1789 and decisions of this Court.

In contrast to transactions conducted at arm's length between strangers, Arkansas law imposes an affirmative obligation upon anyone in whom trust and confidence is justifiably reposed to act with candor and the utmost good faith in dealing with his *cestui que trust.* The policy is set forth in *Taylor v. Gordon,* 169 Ark. 1132, 278 S.W. 26 (1925):

> "The principle, we think is well settled that a trustee or one who occupies a relation of confidence in the management or the sale of property cannot deal with it in any manner for his own benefit . . ." (at 1142)
>
> "Where an agent who is intrusted with the sale of property purchases it himself without disclosing the fact that he is the purchaser to the owner, the sale will be cancelled in a court of equity at the instance of the owner . . ." (at 1142)
>
> "The burden is on the trustee or agent occupying the confidential relation to show that the transaction was in the utmost good faith; otherwise a court of equity will set it aside" (at 1142-43)

The fiduciary, not the *cestui,* has the burden of proof; the fiduciary's failure to disclose his personal interest in a transfer of the *cestui's* property creates an irrebutable presumption of fraud. Both are substantive state rights which federal courts are obligated to apply in diversity cases. *Cities Service Oil Co. v. Dunlap,* 308 U.S. 208 (1939) (burden of proof); *Dick v. New York Life Ins. Co.,* 359 U.S. 437 (1959) (presumptions).

If Respondents are fiduciaries with respect to the Lanes, a matter assumed, but not decided, by the District Court, *see Lane v. Peterson,* 851 F. 2d 193, 196 (8th Cir. 1988), they, not the Lanes, had the burden of proving full disclosure and good faith dealing. Under the holding in *Taylor v. Gordon,* Respondents' failure to disclose their beneficial interest in the Trust rendered the transfer of stock of the Lane Companies voidable at the request of the Lanes. Neither the District Court nor the Court of Appeals conidered Arkansas law regarding self-dealing by fiduciaries. Neither court cited contrary Arkansas authority nor did either court cite Arkansas authority for its holding that Respondents breached no fiduciary duty to the Lanes.

Limits on the authority of federal courts to decide diversity cases was the heart of *Erie R.R. Co. v. Tomkins,* 304 U.S. 64 (1938). This Court held in *Erie* that Section 54 of the Judiciary Act of 1789 constitutionally mandated federal courts to apply state judicial law as well as state statutory law as their rule of decision in diversity cases. Federal courts have no discretion under Section 54 to apply any other rule of decision except applicable state law. In the instant case, neither court ascertained or applied Arkansas law pertaining to self-dealing by fiduciaries; they applied their own rule of decision creating the kind of conflict between federal and state courts *Erie* sought to eliminate.

It is important for the efficient operation of the federal judiciary for this Court to determine whether a federal court exceeds its authority under Section 54 if it fails, for any reason, to ascertain and apply state substantive law in diversity cases. To insure there is not subtle erosion of the force of *Erie,* the federal courts should be required to ascertain and apply state law as a jurisdictional

requirement in diversity cases. Only a clear holding by this Court will insure uniform compliance with the mandates of *Erie.* Such a requirement imposes no unwarranted burden on the federal judiciary: in fact, the rule will promote judicial economy by forcing courts to consider the question and will prevent the issue being overlooked or avoided. This Court should decide, uniformly and finally, that federal courts exceed their jurisdiction to decide diversity cases if they fail to apply state substantive law.

II. The District Court's failure to apply Arkansas substantive law regarding self-dealing by a fiduciary constitutes extraordinary circumstances justifying relief from judgment pursuant to Rule 60(b)(6) and raises important, unresolved questions of policy regarding final judgments.

By not applying the law of Arkansas regarding self-dealing by a fiduciary as required under *Erie,* the District Court has deprived the Lanes of substantive rights created by the state of Arkansas. If the policy set forth in *Taylor v. Gordon* had been applied, the Lanes could void the transfer of their stock to Respondents. Depriving the Lanes of this fundamental right, a denial of equal protection and due process under *Erie,* works a manifest injustice. Moreover, allowing the judgment to stand, permits a fiduciary to profit from his dealings with his *cestui* without full disclosure of the fiduciary's interest and without insistance upon scrupulous fairness on the part of the fiduciary. Such a result is bad public policy which encourages faithlessness to trusts and does not accord with either Arkansas law or federal law. *See, Michoud v. Girod,* 4 How. 503 (1846); *see also Meinhard v. Salmon,* 249 N.Y. 458, 164 N.E. 545 (1928) (opinion by Cardozo, Chief Judge).

The policy favoring the finality of judgments is in direct conflict with the policies underlying *Erie*. This Court has held that federal courts have the power under Rule 60(b)(6) "adequate to enable them to vacate judgments whenever such action is appropriate to accomplish justice," *Klapprott v. United States*, 335 U.S. 601, 603 (1950); *See also, Liljeberg v. Health Services Acquisition Corp.*, 108 S. Ct. 2194 (1988) ("justice must satisfy the appearance of justice"). The policy favoring finality should not be used to promote injustice. Respondents held positions of trust. As court appointed officers they should not be shielded from the consequences of a breach of that trust. Respondents have not relied upon the District Court's judgment to their detriment, *see, Liljeberg, supra.* There is no prejudice to Respondents if the judgment is vacated and their conduct measured against the standard established in *Taylor v. Gordon, supra.* Respondents are not entitled to retain a windfall because the District Court neglected to apply the appropriate state standard. This Court should make clear that the requirements of *Erie* take precedence over the policy favoring the finality of judgments.

CONCLUSION

For the reasons set forth herein, this petition for certiorari should be granted. The Court of Appeals decision should be reversed and the case be remanded to determine the issues in accordance with Arkansas law regarding self-dealing by fiduciaries.

Respectfully submited,

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APPENDIX A—OPINION OF COURT OF APPEALS

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Clift C. Lane, et al.,

Appellants

v.

John E. Peterson, Jr., et al.,

Appellees.

Nos. 89-1329
89-1508

Submitted: June 28, 1989
Filed: July 17, 1989

Before ARNOLD, BOWMAN, and MAGILL, Circuit Judges.

PER CURIAM.

Clift and Dorothy Lane appeal from the District Court's[1] order denying their Rule 60(b) motion to vacate judgment, and sanctioning the Lanes and their attorney, Raymond T. Mundy, under Federal Rule of Civil Procedure 11.[2] We affirm.

The Lanes owned a poultry business which became the subject of a Chapter 11 reorganization proceeding. When the plan did not generate the expected funds, the Lanes agreed to transfer their stock to a panel established as part of the reorganization plan. Less than one year

later, the panel sold the stock for $35 million, and the Lanes filed a diversity action against the panel seeking to recover the stock or its proceeds. After a five-day bench trial, the Court denied relief. On appeal the Lanes argued that the District Court erred in failing to impose a constructive trust on the sale proceeds, but did not attack the Court's interpretation of Arkansas law. The panel appealed the Court's denial of their request for sanctions under Federal Rule of Civil Procedure 11. On June 30, 1988, we affirmed the decision and the denial of sanctions. *Lane v. Peterson,* 851 F.2d 193 (8th Cir. 1988). The Court denied rehearing on August 2, 1988.

On December 21, 1988, Mundy, a New York attorney who had not represented the Lanes previously, filed a motion to vacate judgment. He argued that the District Court committed legal error in failing to apply Arkansas trust law, and that such error rendered the judgment void under Rule 60(b)(4) or, alternatively, gave rise to exceptional circumstances justifying relief under Rule 60(b)(6). The Court denied the motion and assessed sanctions against the Lanes and Mundy. This appeal followed.

The District Court's opinion and this Court's affirmance were based on the application of Arkansas law. The Lanes' Rule 60(b) motion is merely a belated effort to

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1. The Hon. Oren Harris, Senior United States District Judge for the Eastern and Western Districts of Arkansas.

2. This Court lacks jurisdiction to decide whether sanctions were properly assessed against Mundy because he is not listed as a party on the notice of appeal. See *Rogers v. National Union Fire Ins. Co.,* 864 F.2d 557, 559-60 (7th Cir. 1988).

relitigate issues which should have been raised, if at all, on direct appeal. The Lanes have not demonstrated that they were precluded from raising these issues earlier.

In assessing sanctions, the District Court noted the lengthy prior proceedings, and found that since the appellate process had concluded, the motion was improper, and that Mundy's attempted action was improvident and contrary to the rules. We cannot say the District Court's findings are clearly erroneous, nor its conclusion that Rule 11 was violated, in error. See *Kurkowski v. Volcker,* 819 F.2d 201, 203 n. 8 (8th Cir. 1987). The Lanes do not challenge the amount of the sanction imposed.

Affirmed.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B—ORDER OF DISTRICT COURT

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
TEXARKANA DIVISION

CLIFT C. LANE, et al

Plaintiffs,

vs.

JOHN E. PETERSON, JR., et al,

Defendants.

ORDER

NO. 86-4069

In this action the Court after several days of trial entered a Judgment July 2, 1987, dismissing the complaint filed by the plaintiffs, Clift C. Lane and Dorothy P. Lane, Individually and as Trustees under the above noted Trusts and in favor of the defendants. The Judgment on behalf of the defendants was entered pursuant to an extensive Memorandum Opinion entered by the Court following the lengthy trial and briefs filed by counsel for the parties.

The plaintiff were adequately and well represented by Howard Waldrop, Charles J. Hlavinka and Norman Russell of the well-known law firm of Atchley, Russell, Waldrop & Hlavinka of Texarkana, Texas. The defendant were represented by Ronald A. May, Isaac A. Scott, Jr., and Gregory T. Jones of the well-known law firm of Wright, Lindsey & Jennings of Little Rock, Arkansas.

The Judgment entered by the Court was appealed to the Eighth Circuit Court of Appeals. The appellate court affirmed the decision of this court and the motion for a rehearing by the appellate court was considered and denied on August 2, 1988.

This Court has now received a motion on behalf of the plaintiffs to vacate the Judgment entered by this court July 2, 1987. The motion at this late time of filing for the court to vacate the original judgment and enter judgment in favor of the plaintiffs was filed by the Honorable Raymond T. Mundy, Montebello Park, Suffern, N.Y. 10901. Although Mr. Mundy is an out-of-state attorney he represented himself as attorney for the plaintiffs without any indication of a relationship with the law firm representing the plaintiffs throughout the trial of the case and through the appeal processes. Not having had any indication of his interest as an attorney for the plaintiffs and no indication of his association with the previous law firm or any other law firm in the State of Arkansas, the motion to vacate the judgment of the court was improvidently entered.

On receiving the proposed motion filed by Mr. Mundy on behalf of the plaintiffs the court directed a letter to Mr. Mundy advising that his motion was filed by the clerk December 21, 1988, and a decision by the court in behalf of the defendants, that the case was appealed to the Eighth Circuit Court of Appeals and affirmed. Also, that a motion for a rehearing by the Court of Appeals, Eighth Circuit, was denied on August 2, 1988. He was also advised that there was no motion for a certiorari to the Supreme Court and the time for any additional action to be taken in the case had long since passed.

With the proposed motion to vacate Mr. Mundy, purporting to represent the plaintiffs, filed a request for permission to appear in behalf of the plaintiffs in the identified case.

In response to the proposed motion to vacate judgment counsel for the defendants opined that the defendants were being harassed. Further, that the case was thoroughly tried to the court and the plaintiffs were ably represented by counsel and the bench trial took place over five lengthy, consecutive days. The motion additionally was untimely and final consideration through processes had been determined in the case.

The Court having concluded that the motion was entered improvidently and the Court being well and sufficiently advised of the entire record, concludes that the motion to vacate is untimely and should be denied.

IT IS, THEREFORE, CONSIDERED, ORDERED AND ADJUDGED that the motion to vacate by an attorney that has not heretofore been noted in the record in any manner and that the motion being untimely and contrary to the rules of the court be and the same is hereby denied.

DATED this 18th day of January, 1989.

s/ Oren Harris
UNITED STATES SENIOR DISTRICT JUDGE

U.S. DISTRICT COURT
WESTERN DIST. ARKANSAS
FILED
JAN 18 1989

APPENDIX C—SUPPLEMENTAL ORDER OF DISTRICT COURT

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
TEXARKANA DIVISION

CLIFT C. LANE, Individually, ET UX.,
PLAINTIFFS,

VS. NO. 86-4069

JOHN E. PETERSON, JR., ET AL.,
DEFENDANTS.

SUPPLEMENTAL ORDER

This is a Supplemental Order to the Order entered by the Court January 18, 1989, denying the motion previously entered by a Mr. Raymond T. Mundy, Montebello Park, Suffern, NY 10901, representing himself as attorney for Clift C. Lane and Dorothy P. Lane in this above-identified action. The Court included in its previous Order dated January 18, 1989, the fact that Mr. Mundy had made no request to this Court to be permitted as an out-of-state attorney to appear in behalf of these plaintiffs. Other well known and highly qualified attorneys had represented the Lanes in a substantial trial to the Court.

The Court in its previous order referred to the fact that the motion purported to be filed by Mr. Mundy was improvidently entered in that he was not authorized to appear nor did he associate himself with a local attorney for such purposes.

As previously noted, this case was tried to the Court and concluded July 2, 1987. It was appealed to the Circuit

Court of Appeals, Eighth Circuit. The Court's judgment on behalf of the defendants was affirmed by the Circuit Court of Appeals, Eighth Circuit. The Eighth Circuit Court's opinion was filed June 30, 1988. Appellants petition for rehearing was denied August 2, 1988. In that the case had been litigated and appellate action concluded, it is obvious that this Court is without jurisdiction and such motion to vacate is obviously improper.

In response to the attempted filing by the Honorable Raymond T. Mundy, the Honorable Ronald A. May and Honorable Gregory T. Jones, of the law firm of Wright, Lindsey & Jennings, Little Rock, Arkansas, filed on February 1, 1989, a motion for sanctions. The motion relies on the several days of trial in the case, the appeal process concluding and decision for the defendants affirmed, and, therefore, claims that the motion is not only ill advised, but contrary to Rule 11 and 28 U.S.C. §1927 vioalted. It is the contention of counsel in the motion for sanctions that the action taken is for harassment, contrary to the rules and an attempt to relitigate the case all over again and virtually amounted to bad faith.

With motion for sanctions counsel files an itemized statement of disbursements, attorneys' fees and other costs in the sum of $3,262.79.

In the response to the motion for sanctions filed by defendants' counsel, the Honorable Robert T. Mundy, posing as attorney for the Plaintiffs, Lanes, has filed a response to the motion for sanctions, together with a brief in support thereof.

The Court can only conclude that the attempted action of counsel purporting to represent the Lanes is not

only an improvident act, but action contrary to the rules. Counsel purporting to represent the Lanes was obviously aware of the fact that this matter had been concluded months before his attempt to involve this Court further by passing judgment on a motion to vacate after the matter had been completely litigated and disposed of months before the filing of the motion. The Court is of the opinion that the motion for sanctions should be granted.

IT IS, THEREFORE, CONSIDERED AND ADJUDGED that the plaintiffs in this action and the Honorable Raymond T. Mundy purporting to appear as their attorney and each of them are hereby required to pay defendants' costs in responding to the motion, including defendants' attorney fees; that judgment herein be and is hereby entered jointly and severally against the Lanes and the Honorable Raymond T. Mundy, purporting to act for each of them, Lanes, in behalf of the defendants in the amount of Three Thousand Two-Hundred Sixty-One Dollars and Seventy-Nine Cents ($3,261.79), such amounts to be paid to defendants' attorneys, Wright, Lindsey & Jennings within ten (10) days from the entry hereof.

DATED this 3rd day of March, 1989.

s/ Oren Harris
UNITED STATES SENIOR DISTRICT JUDGE

Supreme Court, U.S.
FILED
NOV 14 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-594

In The

Supreme Court of the United States

October Term, 1989

CLIFT C. LANE and DOROTHY P. LANE,

Petitioners,

v.

JOHN E. PETERSON, JR., WALTER W. MINGER, and EDWARD H. COVELL,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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STATEMENT OF THE CASE

It is difficult to respond with equanimity to Petitioners' Statement of the Case. It so grossly misrepresents and distorts the record in this case that specific corrections are inadequate. Respondents refer the Court to the Appendix hereto, which is the District Court's original Memorandum Opinion of July 2, 1987, in support of the judgment which Petitioners are now seeking to set aside under Rule 60(b) of the Federal Rules of Civil Procedure. What follows is a summary of that opinion.

Petitioners and the companies of which they were the sole owners filed a Chapter 11 proceeding in November, 1982. A Plan of Reorganization was confirmed in August, 1984. It included provisions for a Special Panel to advise Petitioners on the management of their companies. Respondents were the members of that panel. They did give advice to Petitioners, which Petitioners chose to ignore. Because of persistent mismanagement, the bankrupts defaulted under the Plan of Reorganization. They were facing imminent liquidation, including liquidation of Petitioners' personal assets, since Petitioners had personally guaranteed about half of their companies' liabilities, which exceeded $100,000,000.

Petitioners tried to sell their companies for more than eight weeks. They were unable to secure a single offer during that time. The companies had a negative net worth of more than $8,000,000 and there was overwhelming evidence that Petitioners' stock in the companies had no value. It is not true that Respondent Minger "received an offer to purchase the Lane Companies after the Special Panel assumed control." (Petition 4.) On June 24, 1985,

Don Tyson of Tyson Foods, Inc., told Respondent Minger that he would be interested in operating the companies for sixty days after the Petitioners were out of management to see if he wanted to buy the companies. No follow-up on this conversation ever took place.

Creditors, aware of the likelihood of liquidation, indicated that they wished Petitioners to give up management and ownership of the companies. Petitioners urged Respondents to take over as directors under the Plans' provisions before the cure dates on the numerous defaults expired. Respondents originally refused. They finally agreed to do so, but only on condition that Petitioners give up their stock in the companies. This was in deference to the wishes of creditors that Petitioners relinquish their stock, as well as Respondents' own concern that Petitioners not be in a position to interfere with new management.

Petitioners resigned as officers and directors and assigned their stock to Respondents who received it as trustees for the companies' employees. The assertion in the Petition (p.4) that Respondents are "the sole beneficiaries of the trust" is false. *See* 851 F.2d at 197 (Appellate Court opinion on appeal of original judgment herein). The court below found that Petitioners "clearly and completely understood" the import of their actions in turning over the companies to Respondents. Petitioners were given a consulting contract paying them $150,000 over two years.

Respondents assumed management of the companies and put into effect the policies and operations they had previously and unavailingly recommended to Petitioners.

The companies began to make a profit. Respondents were able to sell off an unprofitable part of the business at a profit. Although the market for the companies' products had diminished seriously during the later period of Petitioners' management, Respondents were able to improve the quality and marketability of the companies' products.

As the companies' financial condition improved, they suddenly found themselves with a willing large-scale consumer of their product, Tyson Foods. Tyson Foods had contracted to supply poultry products to Burger King, Inc. The demand exceeded Tyson Foods' capacity, and it started buying large quantities of poultry products from Respondents' companies. Eventually Tyson Foods decided to buy the companies in order to protect its access to their productive capacities. This transaction occurred about nine months after Petitioners had transferred their stock to Respondents.

About three months later Petitioners filed this suit seeking to obtain the proceeds of the Tyson sale for themselves. Extensive discovery occurred and pre-trial and post-trial briefs were submitted by both sides. After the trial court rejected each of Petitioners' claims, Petitioners filed a motion for new trial, which was denied. They appealed to the Court of Appeals, and the judgment was affirmed. They filed a petition for rehearing, which was denied. Petitioners' new counsel, who had never been formally substituted for Petitioners' previous counsel, then filed the motion to reopen. That motion was filed more than seventeen months after the District Courts' judgment attacked herein. The motion was denied, and the District Judge awarded sanctions against

Petitioners and their attorney. That decision was affirmed on appeal. This Petition for Certiorari followed.

SUMMARY OF ARGUMENT

The District Court's Judgment and the Memorandum Opinion on which it was based clearly demonstrate that the law of Arkansas was applied in respect to every issue in the case. Petitioners are trying to relitigate issues which have already been litigated to conclusion. Rule 60(b) provides no basis for relief in these circumstances. The filing of this Petition is frivolous.

ARGUMENT

The decisions of the District Court and the Court of Appeals were based on Arkansas law. Petitioners are not entitled to relief in these circumstances under FRCP 60(b).

It is clear that the courts below recognized this as a diversity case. The original complaint had asserted it to be. This was admitted in the answer. The Court of Appeals so characterized it. (Petitioners' Appendix 2a.)

The trial in District Court went on for five days. Pre-trial and post-trial briefs to the District Court exceeded two hundred pages. Every single argument made on either side was based on Arkansas law. Nothing in the District Court's Opinion suggests that the Arkansas law was slighted or ignored. The Court of Appeals stated specifically in the decision sought to reviewed here:

> "The District Court's opinion and this Court's affirmance were based on the application of Arkansas law." (Petitioners' Appendix 2a.)

Respondents do not in any way concede that the District Court erred in its application of Arkansas law. However, even if it did, Petitioners are not entitled to use Rule 60(b) in what the Court of Appeals called "a belated effort to relitigate issues which should have been raised, if at all, on direct appeal." (Petitioners' Appendix 2a to 3a.)

In the Court below Petitioners relied on Rule 60(b)(4) as well as Rule 60(b)(6). Their Argument makes no reference to Rule 60(b)(4), which has to do with void judgments. No suggestion is made, nor could be made, that the District Court's judgment was void. Consequently that argument has been waived.

Since the judgment attacked by Petitioners' motion was rendered more than a year prior to the motion's filing, the provisions of Rule 60(b)(1), (2) and (3) are unavailable by the Rule's own terms. Petitioners' relief can come only, if at all, under Rule 60(b)(6) having to do with "any other reason justifying relief from the operation of the judgment."

Petitioners do not suggest any reason why they are entitled to the drastic relief afforded under Rule 60(b)(6) except to say that is necessary "to accomplish justice." A quick glance at the District Court's Memorandum Opinion demonstrates that there was no injustice in that decision. Petitioners advance no analysis and cite no cases similar to their own to suggest that Rule 60(b)(6) is applicable to this case. Nor do they attempt to excuse or

explain why they waited more than seventeen months to make their frivolous claim under Rule 60. The case of *Liljeberg v. Health Services Acquisition Corp.*, 108 S. Ct. 2194 (1988), cited by Petitioners emphasizes that such a motion must be made within a reasonable time. 108 S. Ct. at 2204. The District Court found the Petitioners' motion was untimely. (Petitioners' Appendix 6a.)

There is an equally compelling reason why Petitioners' efforts to reopen the proceedings pursuant to Rule 60(b)(6) must fail. As observed by Professor Moore: "After a decision on appeal, a party may not ordinarily reopen a judgment under clause (6) to litigate a matter that either was or could have been litigated prior to or on the appeal." 7 *Moore's Federal Practice*, ¶60.27[1] at p. 60-270 (1987). *See also Ackerman v. United States*, 340 U.S. 193 (1950). This is not the situation where developments in the law either contemporaneous with or subsequent to the initial trial court judgment have materially altered the legal topography. The legal doctrines discussed in the Petition which Petitioners claim are applicable to their case, are ancient cases. There is no reason why they could not have been cited and argued in the trial court or on the first appeal. Since the Court below rejected Petitioners' appeal initially and on rehearing, Petitioners cannot now invoke Rule 60(b)(6) on grounds that could have been raised during that appeal.

Apart from the meritless nature of the Petitioners' claims, there is an even more fundamental reason why certiorari should be denied. While the issues presented were important to the litigants, they can in no sense be construed as matters of pressing jurisprudential concern. No issue of acute public importance is presented in this

case, nor does the controversy raised herein typify issues that have divided the courts of appeals. Purely and simply, this Petition presents a dispute over the application of law to a particular set of facts. Such is not a matter that the vehicle of certiorari is designed to address.

CONCLUSION

The relief sought is not available under Rule 60(b) and Petitioners' motion was untimely and frivolous. The Petition for Certiorari should be denied.

Respectfully submitted,

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APPENDIX

MEMORANDUM OPINION

The plaintiffs in this action, Clift C. Lane and Dorothy P. Lane, (Lanes) individually and as trustees under the above noted trusts, commenced this action on July 30, 1986, seeking judgment decreeing an express trust for the exclusive use and benefit of the Lanes upon the proceeds of the sale, assignment and transfer of the stock in the Lane Processing, Inc., (referred to hereinafter as either LPI or the Lane companies, embracing the nineteen affiliated corporations owned by Clift and Dorothy Lane) to Tyson Foods, Inc., and ordering the defendants, as Trustees, to distribute the proceeds of such sale, assignment and transfer of stock to plaintiffs. (Count one of the complaint).

In Count two of the complaint, the Lanes seek a reformation of the declaration of trust dated July 22, 1985, so as to designate them as the sole beneficiaries thereunder. In Count three, the Lanes seek judgment decreeing a constructive trust upon the proceeds of the sale, assignment and transfer of the Lane Companies stock to Tyson Foods, Inc., with defendants as constructive trustees for the Lanes' sole and exclusive benefit and ordering defendants to distribute such proceeds to them.

The Lanes pray, in the alternative, for relief in the form of rescission in Count four of the complaint. Therein, the Lanes seek judgment rescinding the stock transfer and assignment to defendant and restoring the proceeds of the sale of the stock to Tyson Foods, Inc., to them. Further, in the alternative, the Lanes seek judgment reforming the stock transfer and assignment to reflect the

alleged agreement and intentions of the parties and distributing the proceeds of the sale of the stock to Tyson Foods, Inc., to them. (Count five).

On the date of the commencement of this action, July 30, 1986, the Lanes appeared by counsel before the Court seeking a Temporary Restraining Order without notice to the defendants. At the conclusion of the hearing and upon good and sufficient showing, the Court entered the TRO. On August 7, 1986, the Court extended the TRO to August 15, 1986 under the provisions of Rule 65(d), Fed. R. Civ. P. On August 15, 1986, the parties agreed to extend the TRO to October 14, 1986. *See*: Rule 65(b), Fed. R. Civ. P. On October 14, 1986, an Order was entered extending the TRO to December 13, 1986, upon agreement of the parties pursuant to Rule 65(b). It appears from the record that the TRO expired of its own accord without additional extension of time. No hearing was conducted nor was an Order entered on plaintiffs' Motion for Preliminary Injunction. However, the defendants have not attempted to distribute or otherwise dispose of the proceeds of the sale of the Lane Companies stock to Tyson Foods, Inc., pending resolution of the issues by the Court.[1]

The matter came to be heard on the merits in Texarkana, Arkansas, commencing May 4, 1987. The matter

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[1] However, the defendants advanced $100,000.00 to Frank Barber, an accountant who formerly worked for the Lane Companies. Mr. Barber testified that the advance is subject to refund to the defendants in event Barber does not consummate his proposed purchase of the Avanelle Motel In Hot Springs, Arkansas, by a specified date.

was tried to a completion in five days to the Court, without intercession of a jury. Thereupon, the action was taken under advisement at the conclusion of the testimony. The parties were directed to file post trial briefs on the issues as developed at trial. The briefs having been received, the Court now proceeds to a decision on the issues presented.

The Court incorporates herein findings of fact and conclusions of law pursuant to Rule 52, Fed. R. Civ. P.

The Lanes testified at great length as to the history of the Lane Companies. It is sufficient to state that the Lanes developed their poultry operation from a single flatbed truck hauling feed to a vertically integrated, multimillion dollar, multistate operation consisting of some nineteen affiliated corporations. This growth spanned some thirty-five years of hard work. However, as is sometimes the case, the business outgrew the operators.

The Lanes operated three divisions of their poultry processing operation within the affiliated corporations. The divisions consisted of the Arkansas Division, the Alabama Division and the North Carolina Division. Although each was operated separately, cash generated by each division was often utilized to maintain the other divisions, especially in the years in which the economy disfavored the poultry industry.

The Lanes began to branch out into other businesses. The Lanes purchased stock in banks and savings and loan associations. By 1980, the Lanes had purchased 30% of the outstanding stock in a competing poultry company, Val-Mac, Inc. The Lanes had noted a trend in consumer

purchasing toward "further processed" poultry products.[2] Val-Mac operated facilities capable of further processing. The testimony revealed that the further processed broiler could be sold for a substantially higher price per pound as compared to the broiler or fryer as had been traditionally purchased by the consumer.

The Lanes were not capable of further processing in their plants at the time they began acquiring Val-Mac stock. Thus, in their opinion, with the purchase of Val-Mac their market position would be greatly enhanced, as would their return on their investment.

The Lanes later acquired an additional 47.5% ownership interest in Val-Mac, bringing their interest to 77.5%. Although the purchase price of between $17 and $18 million was paid in cash, the Lanes pledged 1.1 million shares of the Val-Mac stock to Worthen Bank and Trust Company of Little Rock in return for a loan of $10 million. A refinancing agreement was executed to memorialize the transaction. The lending arrangement was in the form of a participation loan with other banking institutions carrying a portion of the indebtedness. Mr. Lane testified that this participation agreement increased the loan limit to $18 million on this transaction. The Lanes'

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[2] "Further processing" of poultry entails more than the usual procedure employed in processing birds. The term utilized extensively at trial to describe this further processed bird is a "WOG", without giblets. Generally, the further processed bird is deboned and the meat is fashioned into a variety of products sold as a convenience to the consumer. Examples of such WOG include the chicken fillet, chicken nugget and other specialty poultry products.

purpose in financing the transaction in this manner was to hedge against the down cycle in the poultry industry.[3]

Also, the Lanes acquired an Arkansas bank and 44% of the outstanding stock in a Denver, Colorado, savings and loan association, 1st S & L. Mr. Lane testified that in 1981 he received an offer to buy the 1st S & L stock at a potential profit of $15 million. (The offer was to purchase the 550,000 shares held by the Lanes for $44.00 per share.). However, soon thereafter, and before the transaction could be consummated, interest rates rose sharply and the profitability of the institution fell dramatically. The prospective buyer of the stock at $44 per share did not exercise his purchase rights.[4]

Mr. Lane testified that the refinancing agreement with Worthen was partially contingent upon the sale of the 1st S & L stock. When the 1st S & L deal fell through, Worthen refused to renew the loan secured by the Lanes' pledge of the Val-Mac stock. Worthen sold the loan to Tyson Foods, Inc., one of the Lanes' fiercest competitors. The Val-Mac stock was sold to Bass Brothers for $20.00 per share.

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[3] The poultry industry, as described by Mr. Lane, has a three year economic cycle. Defendant Edward Covell likewise confirmed this three year cyclical pattern. The industry has historically experienced this three year economic curve, with most losses being incurred every third year of operation.

[4] Lanes did sell the stock later, however. The stock brought only $15.00 per share or $8.25 million gross.

This course of events culminated in the Lane Companies filing for protection under Chapter 11 of the Bankruptcy Code on November 7, 1982, in the Middle District of North Carolina, Greensboro Division. The Consolidated Plan of Reorganization (Plan) contains a succinct summary of these events which led to the filing of this Chapter 11 petition.

The Lanes retained a law firm out of Washington, D.C., Arent, Fox, Kintner, Plotkin and Kahn, to represent them in the bankruptcy matter. The Arent, Fox firm had previously represented the Lanes in an unrelated matter. Mr. William Sullivan of the Arent, Fox firm handled the matter. Also, local counsel out of North Carolina was retained, the Honorable Jerry Tart (now Bankruptcy Judge for the Middle District of North Carolina).

In the course of the bankruptcy proceeding, Mr. John E. Peterson, Jr., (Peterson) a defendant herein, was appointed as an examiner of the bankrupts' estate. Peterson, a CPA, is a retired Vice President of Burlington Industries with extensive experience and training in financial and managerial matters. Through Peterson's duties as examiner, he became familiar with the operations of the Lane companies. He also was befriended by the Lanes.

On July 25, 1984, the Plan was approved. The Plan called for the creation of a Special Panel. [Plan Article VII, §7.05(l)). William Sullivan, as counsel for the Lanes, requested that Peterson serve on the Panel. The other members of the Panel, Walter W. Minger and Edward H. Covell, also defendants herein, were selected by the Lanes, subject to approval by the Bankruptcy Court after

notice to the creditors and a hearing. (§7.05(2) of the Plan.) The Plan further provided that the "(m)embers shall be independent and not presently employed by, or affiliated with, either Lane, Lane's competitors, or the Creditors." (*Id.*).

The Plan required the Special Panel to meet formally on a regular basis, but not less than quarterly. The Plan provided that at every formal meeting, the Special Panel was to review the conformity of LPI, Lane Processing, Inc., with the provisions of the Plan, and thereafter submit any relevant findings or recommendations for LPI's operations to the Board of Directors of LPI. (§7.05(4)).

Section 7.06 specified additional powers and duties of the Special Panel. Subpart (2) provided that each of the members of the Special Panel shall be an ex-officio member of one or more of the Company Committees and shall have such powers and duties as any other member of the Committees. Subpart (3) provided that the Special Panel was to receive all reports, budgets, reconciliations, and financial statements of LPI prepared in the ordinary course of business or pursuant to the provisions of the Plan and that the Panel was to have access, upon request and upon reasonable notice, to all financial and other information of LPI.

Subpart (4) of §7.06 provided that Panel was to have the authority to participate in the preparation of the capital budget (which was be prepared on an annual basis), and to review and approve said budget. Subpart (5) specifically prohibited any merger or acquisition between Lane and another entity without the Lanes first obtaining the approval of the Special Panel.

Section 7.06(7) provided as follows:

> The Special Panel shall succeed to the powers and duties of the Board of Directors of LPI only upon the following conditions:
>
> (A) The death or disability of both members of the present Board of Directors; or
>
> (B) If an Event of Default (provided for in Section 9.01) has occurred.
>
> If the Special Panel has succeeded to the powers and duties of the Board of Directors of LPI under Subsection (B) above, then the Special Panel shall continue to hold such powers and carry such duties until the Event of Default has been cured and the Special Panel certifies in writing that the condition which brought about the Event of Default has been remedied and such Event of Default is not likely to occur again.

Article IX of the Plan addresses Events of Default and Remedies. Section 9.02 provides that the Panel shall have thirty (30) days after the occurrence of an Event of Default to cure same before any Creditor might pursue any of the outlined remedies. This, in essence, granted the Panel an additional thirty day period in which to rectify any Event of Default. Where the Lanes would be allowed only thirty days to cure an Event of Default, the Panel would be afforded the luxury, if such term is appropriate under the dire financial status of the Lanes companies at the time, of sixty days to cure the default.

Section 9.02 outlines the remedies available to the creditors should an Event of Default occur and continue without being cured. The Plan specifically granted the creditors the right to declare their indebtedness due and payable without presentment, further notice or demand.

Also, the creditors were granted the right to pursue any and all remedies under their respective debt instruments, documents and agreements, as well as any remedy available under the law.

The Lanes continued to operate the affiliated companies as debtors-in-possession following appointment of the Panel. The members of the Panel performed their duties as specified in the Plan. During the course of their performance, the Panel made recommendations[5] to the Lanes in an attempt to bolster the deteriorating financial condition of the companies. However, the suggestions were not heeded.

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[5] The Lanes were attempting to develop a line of chicken sausage for marketing. This effort proved to be overly costly and nonproductive. Further, the Lanes were trucking excess laying stock, generally larger, older birds, from its Arkansas production facilities to a processing plant in Fort Worth, Texas. The testimony revealed that the Grannis, Arkansas, and Broken Bow, Oklahoma, processing plants, were not operating at capacity, yet the Lanes insisted on incurring the expense of transportation of these birds to Fort Worth.

Also, there was a lack of rational planning by the Lanes in the balance between breeder flocks and need for chicks by growers. There were substantially more eggs being produced than were necessary to meet the demand for chicks by the growers. Although the excess eggs were marketed, a loss per dozen was being incurred. The testimony revealed that the Lanes also indulged in research and development of a "leaner chicken".

The Panel recommended that each of these items be either eliminated or addressed on a rational basis. At the time, with cash flow at a critical point, these projects were draining resources which could reasonably have been expended in other areas for the long term survival of the companies.

During the period of time from confirmation of the Plan through June 1985, the Lane companies suffered staggering losses. Although these losses were in part due to the economic conditions, i.e. high feed costs, high interest rates, and low market prices, the losses were greatly a result of poor managerial decisions by the Lanes, such as noted above. The stockholders equity in the companies had diminished to a negative $8,197,237.00 by June 30, 1985, with losses for the preceding twelve months totaling $8,917,777.00.

In June 1985, the condition of the companies was such that it became apparent that each of the scheduled payments as required under the Plan could not be made. Thus, Events of Default were inevitable. The occurrence of an Event of Default without cure by August 2, 1985, would have required the Lanes to relinquish their positions as the Board of Directors and as Officers. The Panel would have been required to assume the roles of the Board of Directors under the Plan. Further, an occurrence of an Event of Default without cure could bring about foreclosure on security by creditors and liquidation of the companies.

In order to secure much of the needed capital for the operations, the Lanes had executed personal guaranties in excess of $50 million. Although the Lanes were entitled to claim exemptions for certain property under state law and the Plan provided for the retention of certain "personal assets", as defined in the Plan, in the event of a liquidation the Lanes' personal assets would be subject to the claims of creditors. (Section 9.02, noted above). The assets in jeopardy were valued in excess of one million dollars.

The Lanes made an offer to the employees and the growers whereby, in return for accepting a decrease in pay, the Lanes would issue stock to these employees and growers. This proposal caused grave concern on the part of the Panel and the creditors. The proposal was in direct contravention of the regulations of the Securities Exchange Commission and the Arkansas laws concerning stock offerings. This proposal constituted an event of default.

Approximately June 24, 1985, Tyson Foods approached defendant Walter Minger about possibly acquiring the Lane operation. This inquiry was relayed to the other two panel members. Tyson's interest was to initially operate the companies for a period of time in order to determine whether to purchase the companies. The Tyson proposal was conditioned upon the Lanes being out of the operation prior to any take over. Tyson's interest was not conveyed to the Lanes despite the fact that Clift Lane testified that he had been openly seeking a purchaser for the companies.[6] Neither Lane nor Don

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[6] Clift Lane testified at length about his efforts to sell the companies prior to divestment. Lonnie A. "Bo" Pilgrim, the owner of Pilgrim's Pride, an independent poultry company, testified that he made more than one offer to purchase the companies both from the Lanes and from the Panel after divestment. However, Mr. Lane refused Pilgrim's offers as being too low. The Panel also believed that Pilgrim's offers were not reasonable.

Pilgrim's testimony is viewed by the Court as being biased. Pilgrim's credibility is tainted by his attitude toward

(Continued on following page)

Tyson, Chairman of Tyson Foods, held the other in high esteem.

Less than one week earlier, June 19, 1985, Clift Lane had estimated that he could sell the entire operation for around $35 million. This statement was made in the course of a meeting in Greensboro, North Carolina, with the Panel and creditors. The Lanes place emphasis upon this sales price estimate because, in dollar amount, it mirrors the price paid by Tyson. However, in January

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(Continued from previous page)

the Panel. Pilgrim wanted to purchase the Lane operation. However, even according to Clift Lane, Pilgrim wanted to purchase at a "fire sale." The industry is highly competitive. The purchaser of an operation the size of the Lane companies could have gained substantially in production, output and market share.

Lane sought to sell the Alabama Division. Lane wished to utilize the funds from such a sale to stabilize the sagging cash flow in the North Carolina and Arkansas Divisions. However, the creditors refused to approve a transfer of funds from any such sale to either of the other two divisions, in that such a transfer would be contrary to the terms of the Plan. Thus, efforts to sell the companies in parts was abandoned by the Lanes.

Lane employed Donald Armbrust, a journeyman in the commercial financing area, as a broker of sorts in attempt to arrange a sale. Armbrust testified at length concerning a package he developed. He stated that the package was presented to ConAgra, Sparks Commodities and Roga, a South African entity. Armbrust produced no corroboration of the interest of these companies. Armbrust stated that the discussions with each were via telephone. Armbrust was terminated by the Panel the day following divestment. The Court is not persuaded that any of the contacts with these three entities could rise to the level of a bona fide prospect.

1986, and prior to the Tyson sale, the North Carolina Division was sold. Thus, the sales prices are not substantially equivalent.

As a result of these occurrences, the Panel scheduled a meeting in Grannis, Arkansas, at the Lane offices. The Panel met in Grannis on July 1 and 2, 1985. The Lanes paint a picture of treachery in the mill the night of July 1, 1985. It is admitted by the defendants that they met that night with Mel Sullivan, a ranking employee of Lane, and David Van Bebber, in-house counsel for the Lanes. However, the Lanes have failed to show how this otherwise innocent gathering could be construed as a planning session for a coup against them. It was established by the evidence that there is very little activity in Grannis after sundown. The panel members and Mel Sullivan simply enjoyed a casual dinner together. Thereafter, they retired to Sullivan's home for conversation, where Van Bebber joined them. Peterson testified that the usual topics at such a visit included quail hunting and fishing. Whether there was any mention of the Lane companies or their problems is not determinative of the issues herein.

On July 2, at a meeting with members of the Panel and Lanes, the cash flow within the companies was the major issue confronting the continued existence of the companies. Also, the course of action to be taken in light of the Notices of Default, which had been received by the Lanes, was a subject of discussion.

Dorothy Lane insists strongly that she and Peterson secretly met in her office on that July 2, after the regular meeting with the Panel, to discuss a proposed transfer of stock and managerial responsibility to the Panel. Dorothy

Lane contends that Peterson assured her that the Panel did not want her money and that the stock, if transferred, would be held for her and Clift as beneficial owners. This alleged promise by Peterson is the primary basis for the Lanes' claims for relief. Dorothy Lane told no one, not even her husband, about this alleged secret agreement.

Peterson specifically denied that he told her the Panel would hold the stock for the benefit of the Lanes. He admits that he stated that the Panel did not want her money. Of course, the purpose for the Panel's existence was to guide, advise and assist Clift and Dorothy Lane in rehabilitating their companies, not drive them to financial ruins. Peterson and the other Panel members recognized that it was in the best interests of the Lanes to avoid a liquidation. They sought to protect that interest. The Panel also sought to return the companies to profitable entities by solidifying their financial positions. Unless and until the Panel gained the power to manage the companies, rather than standing in the role of advisor, their efforts would be fruitless. The Lanes had previously chosen to disregard meritorious recommendations made by the Panel. *(See* note 5, *supra* and at page 17).

The Court has reviewed the testimony concerning this alleged secret agreement and finds that the testimony of Dorothy Lane lacks credibility. The strong weight of the evidence bears in favor of Peterson's version of the events occurring July 2, 1985. It is questionable that Dorothy Lane would have received such a commitment from Peterson then not relayed same to her husband. It is also questionable that Peterson would have entered an agreement of such magnitude without consulting Minger and Covell, the other two Panel members. In the event that

Peterson might have entered such an understanding, he would have surely then conveyed the matter to Minger and Covell. Both Minger and Covell disavowed any knowledge in this regard. The Panel operated upon a vote of the majority, not the ex parte, secret approval of a single member. Plan, Article 7.05(4). Peterson's assent to this transaction would have been subject to the approval of at least one of the remaining two Panel members. All other matters affecting the Panel's operation were presented in such a fashion.

Between July 2 and July 17, the creditors "floated" a proposal that the Lanes would, prior to August 2, relinquish control, as directors and as stockholders, to the Panel. (Pursuant to the Plan, on August 2 the Panel would have been required to assume such control if there was no cure of the Events of Default.) In return the creditors would release the personal guaranties and allow the Lanes a short-term consulting contract. A large creditor rejected the proposal prior to any action being taken by the Lanes. The Lanes made no mention of any secret agreement with Peterson while this proposal was being considered.

Thereafter, the Lanes came to a full realization of the depth of their dilemma. Dorothy Lane suggested to Peterson that, if she (and Clift) could be released from the personal guaranties, they would relinquish control of the companies. While the Lanes had dedicated their life's work to the companies, the retention of their remaining personal assets, including their homes in Grannis and Dallas, Texas, vehicles, jewelry, clothing and a number of farms embracing several thousands of acres of land, became of the utmost importance. The consequences of a liquidation had been explained to the Lanes by letters from their attorney, William Sullivan.

As each day passed the financial position of the companies deteriorated. The cure periods on the Events of Default were rapidly expiring. The Panel met in Washington, D.C, in an office within the Arent, Fox firm on July 17, 1985. This location was chosen primarily out of convenience to the Panel. Although the Panel had on several occasions expressed strong reservations about assuming control, the Panel unanimously agreed that they would accept an early take over of the companies, as requested by the Lanes, if and only if the Lanes relinquished all control and power in the companies, including a transfer of all stock. Covell expressed a fear that, if the Lanes did not surrender their ownership, they could assert their power to defeat any program implemented by the Panel. Also, the Panel initially believed that they could use the stock to attract new and qualified managerial personnel.

The Panel's proposal was conveyed to William Sullivan, counsel for the Lane companies, who immediately contacted the Lanes through Dorothy Lane. While the Panel was in the meeting, Sullivan relayed the Lanes acceptance of the proposal. Dorothy Lane testified that she approved of Sullivan's working with the Panel in working out the details of the transfer. Acceptance of the proposal was subject to a potential sale of the companies. Again, Dorothy Lane made no mention of the alleged secret agreement to Sullivan or any other person.

The proposal did not initially require the stock to be placed in trust. The original proposal was to "turn the stock back to the companies." However, after assessing the ramifications of such a transaction, it was determined that the companies could not operate without outstanding stock. Thus, the idea of the creation of a trust was

suggested by Sullivan. The idea of a trust was not conveyed to the Lanes.

It was the opinion of the Panel that the stock was without value, "worthless", at that time. The net worth of the companies exceeded a negative $8 million. The stock carried a negative book value. The physical conditions of the facilities had been neglected because of the cash shortfalls. Although the plan called for expenditure for capital improvements; there were simply insufficient funds to perform all the improvements that were needed.

The date of July 22, 1985, in Grannis, Arkansas, was established for consummation of the stock transfer agreement and related documents. The duty of preparing the necessary documentation was placed in the hands of Sullivan and his law firm. The final product was not concluded until late the evening of July 21, 1985, a Sunday. (Sullivan testified that he discovered a slight error which was corrected on July 22. However, the correction did not substantively alter the documents.)

The Lanes place great significance upon Sullivan's failure to teletype copies of the documents to them prior to July 22. In the course of the bankruptcy matter, Sullivan had teletyped important information to them on a regular basis. However, considering the time and effort expended in merely concluding the drafting, the time at which the product was finalized, and the fact that Sullivan then was required to travel halfway across the country, the Court finds that Sullivan did that which could reasonably have been expected under the circumstances. In fact, it required a monumental effort to conclude this phase of the transaction within the time frame allowed.

In route to the meeting in Grannis, the Panel members met at the Amfac Hotel near Dallas-Fort Worth airport on July 21, 1985. Sullivan arrived there that evening with the necessary documents. Of special importance, the Panel was for the first time made privy to general provisions of the trust instrument that evening. Upon being informed of the essence of the instrument by William Sullivan, the Panel approved the trust idea there.

The following morning the Panel and Sullivan traveled to Grannis, via Texarkana. Upon arrival around the noon hour, lunch was taken in the lunchroom at the Lane building. After lunch, the Lanes met with their tax consultants concerning the tax ramifications of their proposed transactions. Thereafter, the Panel, the Lanes, Sullivan, Tart and Van Bebber met in a conference room for execution of the documents. The "Revised Lane Agenda"[7] had been previously prepared by Sullivan. This agenda was followed strictly.

As each item was presented to the interested parties, it was briefly explained by William Sullivan. The Lanes

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[7] The Revised Lane Agenda contained thirteen separate items: (1) Execution of Statement; (2) Execution of Declaration of Trust; (3) Execution of Certification and Indemnity re lost Lane Processing, Inc. stock certificates; (4) Execution of Written Consents of Directors concerning issuance of original or replacement stock; (5) Execution of original or replacement Stock Certificates; (6) Resignations executed; (7) Written Consent of Shareholders executed; (8) Stock transfer agreement is executed; (9) Endorse and deliver stock certificates to trustees; (10) Written Consent of New Directors; (11) Agreement relating to Consulting and Certain Assets is executed; (12) New stock certificates are executed; and (13) Distribution of Press Release.

were afforded the opportunity to discuss any matter concerning any of the documents as they desired. The testimony revealed that the only controversy arising that afternoon concerned the Agreement relating to Consulting and Certain Assets, item 11 on the agenda. Clift Lane initially reacted adversely to the provision that his consulting agreement could be terminated on seven days notice after any reasonable determination of material breach of the agreement or after any liquidation or sale of the companies. Paragraph 1.03 of Agreement. After a brief conference, Dorothy convinced Clift to sign this agreement.

The Lanes make much ado about the fact that the entire agenda was completed in less than two hours. From the testimony, the Court finds that the Lanes clearly and completely understood the nature and the substance of each item which they signed that date. This is evidenced also by the fact that, while the Consultancy Agreement was the eleventh item on the agenda and the disputed paragraph was located on the third page of that document, the Lanes tended to not merely sign each item mechanically. Instead, though they did not closely scrutinize each line of each document, they did give consideration to the nature and circumstances of the transactions. Some of the items, such as the execution of statement (item 1), execution of original or replacement stock certificates (item 5), execution of resignations (item 6), execution of written consent of shareholders (item 7), and endorsing and delivering stock certificates to trustees (item 8) required little more than the time necessary for the Lanes to affix their signatures to each document.

Furthermore, the Panel understood the nature of the matters which required their signature, thus, the signing of the trust instrument and the execution of new stock certificates merely required the time necessary for the signatures to be affixed thereto.

The Lanes were provided a copy of the press releases which reflected that they had relinquished' "total control over the corporate stock and other assets" (Agenda Item 13). The meeting was then adjourned.

Although neither Lane was provided a copy of the trust instrument, the Panel was under no obligation to do so. Dorothy Lane asked Peterson for a copy but he politely refused.

Following the meeting with the Lanes, the Panel, acting as the directors of the Lane companies and the trustees of the trust holding the stock to said companies, met with management personnel, then with employees. Both groups were informed that the employees were the beneficial owners of the companies. Mrs. Lane was informed by employees and by Armbrust that the stock was being held in trust for the employees.

The Panel assumed its new duties with vigor. Each member was accompanied by lofty credentials. Peterson, a C.P.A., has much experience in financial and industrial management. Minger is a retired loan officer with the Bank of America, specializing in agri-business and finance. Covell is the retired operator of an integrated poultry business and is now director of the Federal Reserve Bank at Richmond, Virginia. Covell maintained a poultry consulting service after his retirement from the processing business.

Excess programs such as the chicken sausage project and the trucking of birds to Fort Worth were discontinued. The Fort Worth plant was closed. The production at the Grannis and Broken Bow plants, which were operating at below capacity while birds were being trucked to Fort Worth, was increased. New quality control standards were developed. The improvements in quality control cut the amount of discounts and allowances for shrinkage at the dock of a buyer. The Panel also eliminated some field and general employees and streamlined middle management. A marketing plan was also implemented.

At the time the Panel assumed control, the companies were operating on a marginal basis on their feed supplies. This was compounded by the cancellation of the bond on their bills of lading. Without feed the growers could not deliver birds for processing. Also, the lack of feed would cause the loss of egg production. The companies had no access to trade credit or institutional credit. There had been no specific marketing plan. Rather, the Lanes exercised a marketing plan of "spot dumping." There were no regular buyers for the products.

Although the Panel made the determination that a sale of all or any part of the companies would be in the interest of the trust, they concentrated their efforts toward improving profitability. The Panel determined that the Lane companies should be a going concern prior to any sales offerings. The companies would not, otherwise, have been a marketable item, at least not marketable at any reasonable price.

The Panel negotiated a contract with Tyson Foods for the delivery of WOGs. This contract was profitable and

provided a steady market. Thus, the cash flow stabilized. As time passed, the quality control continued to improve, as did efficiency and output.

Late in the fall of 1985, the Panel negotiated for the sale of the North Carolina Division to Townsend, Inc., a Delaware processing company. This sale netted, after satisfaction of the outstanding indebtedness against the North Carolina operation, a profit of $3 million to the Lane companies. The North Carolina Division had carried a substantial percentage of the indebtedness of the Lane companies. This division was also in the poorest physical condition of the three divisions.

The improvement of the companies was not totally due to the work of the Panel, however. The market stabilized with price climbing from an industry average of 4.15 cents per pound in June 1985 to 6.16 cents per pound return in March 1986. Feed cost dropped as broiler prices increased. However, upon cross examination of Mr. Covell, plaintiffs' counsel developed that under the comparative analysis of costs and other factors of different companies, i.e. Agrametrics, as developed by Mr. Covell and another individual, the Lane companies ranked dead last in the industry at the time the Panel assumed control. Although the Lane companies remained below the industry average, the Panel substantially improved the industry standing of the Lane companies within the short period of time they operated the companies.

In March 1986, the Panel began negotiating with Tyson Foods for the sale of the Lane companies. Tysons' interest in purchasing the Lane companies grew out of the Lane companies' exceptional performance on the

WOG contract. Had the Lane companies not improved in all aspects of its production, processing and marketing through the efforts of the Panel and the employees, it is extremely doubtful that Tysons would have entered such negotiations. A Letter of Intent was later executed.

In May 1986, a Stock Purchase Agreement was entered between Tyson Foods, Inc., and the Lane companies, with the Panel members acting on behalf of the Lane companies. A purchase price of $35 million was negotiated, payable in $15 million cash and an installment note of $20 million payable in ten yearly installments.

These funds have been maintained by the Panel as Trustees for the benefit of the named trust beneficiaries. The designation of beneficiaries in the trust instrument has been amended on two occasions, more clearly delineating the class of beneficiaries.

The Lane companies' bankruptcy matter has, for all practical purposes, been concluded. There remain to be made some payments to unsecured creditors who cannot be located. Otherwise, all the requirements under the Plan have been fulfilled. The Lanes have been absolved from liability on their personal guaranties which exceeded $50 million. Their interest in protecting their personal assets from creditor claims has been satisfied. The Panel avoided both liquidation of the Lane companies and foreclosure on the creditors' security, including the personal guaranties.

The Court is asked to impose an express trust for the benefit of the Lanes. Based upon the facts adduced at trial and the record as a whole, the Court finds that the entire

agreement of the parties, i.e. the Lanes and the Panel, is embodied in the instruments executed July 22, 1985. The Stock Transfer Agreement contains an integration clause, specifically reciting that the entire agreement and understanding of the parties concerning the transfer of the stock is set forth in that instrument. Under the terms of the agreement the Lanes transferred all stock and the responsibilities and burdens of ownership unequivocally. Both Clift and Dorothy Lane signed the agreement without threat, coercion or intimidation. The agreement was freely entered and for good and valuable consideration.

The burden is upon the Lanes to prove such an express trust by clear and convincing evidence. *Thom v. Geyer*, 254 Ark. 718, 497 S.W.2d 689 (1973); *Moore v. Lawrence*, 252 Ark. 759, 480 S.W.2d 941 (1972); *Wargo v. Wargo*, 226 Ark. 36, 289 S.W.2d 879 (1956). As noted heretofore, the issue of whether Peterson secretly promised Dorothy Lane that he would hold the stock in trust for the Lanes turns upon the Court's assessment of credibility. The Court having resolved this issue in favor of Peterson's version of the events occurring July 2, 1985, the plaintiffs have failed to meet their burden on this issue.

Furthermore, the Arkansas Supreme Court, as recognized by the Eighth Circuit Court of Appeals in *American Bonding Co. v. Horde*, 98 F.2d 350 (1938), has declared a strong presumption against the existence of a secretly created oral trust, such as the alleged trust herein. The Lanes have failed to overcome that presumption with the proof adduced.

The Court notes that Dorothy Lane never, prior to the time of the transfer, conveyed this alleged secret trust to

her husband, the only other party to have received any benefit from such an arrangement. The Lanes are hard pressed to establish how Clift could have been relying upon such an oral agreement at the time he executed the documents on July 22, 1985. He was acting pursuant to his own wishes to be relieved of any further obligation or responsibility to the Lane companies, notwithstanding his selfserving statement that he did not know he was giving away the entire business at the time.

Clift testified that Dorothy wanted to "get out early", with no mention of any secret trust. However, some one year later, at the commencement of this action and when he hopes to divide the proceeds of the Lane sale with Dorothy solely, Clift Lane asserts that he was acting pursuant to Peterson's promise. The Court finds this assertion to be totally without credibility.

The Lanes' theory of a constructive trust must likewise fail due to their failure to meet the high burden of proof placed upon them as cited above. The members of the Panel acknowledge that they stood in a special capacity in their roles. Under the Plan the Panel served to aid in the business for the benefit of the Lanes, and the affiliated companies, and the creditors. The Plan further provided that the Panel shall be independent and not affiliated with the Lanes or creditors.

Notwithstanding the Lanes' assertion, the Panel was not privy to any well protected business secrets or privileged, sensitive information, prior to assuming the directorship of the companies. The Panel was privy to financial information pertinent to the success or failure of

the companies. This information was likewise available to the creditors in the bankruptcy action.

Even if the Panel stood in fiduciary position to the Lanes, the Court is of the opinion that there was no breach of any duty owed. The plaintiffs have shown no culpable conduct on the part of the Panel members. Rather, the clear and convincing weight of the evidence shows that the July 22, 1985, events, and the facts leading up to that date, involved no fraud, actual or constructive, or impropriety on the part of the Panel. No violation of confidence occurred, at least, no breach by the Panel members.

The Lanes point out certain facts in support of their constructive trust assertions. The Court is of the opinion that disclosure of the Tyson interest of June 1985 would have served no useful purpose in consideration of the attitude toward Don Tyson held by Clift Lane. As evidenced by Clift Lane's testimony concerning the sale of the Val-Mac stock and Worthen's sale of the refinancing agreement and note to Tysons, Clift Lane harbored a heartfelt dislike for Don Tyson. It can be inferred that Clift Lane would rather have suffered the perils of the bankruptcy matter than sell the operations to his fiercest rival.

Insofar as whether the stock was transferred to the companies ("turned back to the companies") or placed in trust for the employees was of no consequence to the Lanes. They wished to be relieved of the struggles with no cash, the pressures, hardships, and headaches associated with their attempts to salvage the failing operation. The Lanes knew that all of their years of work was

crumbling around them. Their efforts to save the companies had failed.

The mere fact that the defendants, as Trustees and members of the Panel, acquired the stock from the Lanes does not raise any inference of dishonesty or impropriety. No credible evidence of improper conduct has been offered. Rather, the Panel acted in good faith and in fairness in connection with the events surrounding the transfer of stock and execution of the declaration of trust.

The Lanes contend that the Panel should have suggested to them that they might have a need for legal counsel on July 22, 1985. This contention is preposterous. The Lanes were business people with substantial experience in business matters. Further, Clift Lane has been described by the Eighth Circuit Court of Appeals as being a "sophisticated investor and entrepreneur." *Geldermann and Company, Inc., v. Lane Processing, Inc.*, 527 F.2d 571 [8th Cir. 1975). The Court is of the opinion that Clift Lane's status as a businessman has not materially changed since 1975.

Had the Lanes felt that they were in need of legal assistance other than from William Sullivan, they were free to so request. It was pursuant to the Lanes' consent of July 17, and upon their behalf, that Sullivan prepared the documents. The Lanes neither requested advice nor raised any questions of the propriety of any of the instruments presented, aside from the consulting agreement. The Panel was under no duty to make any suggestion pertaining to legal counsel.

The Lanes seek to reform the stock transfer agreement. The burden is upon the Lanes to show by clear and

convincing evidence either a mutual mistake or a unilateral mistake on their part and fraud or other inequitable conduct on the part of the Panel in order for the Court to reform the contract. *McDermott v. United States*, 760 F.2d 879 (8th Cir. 1985); *American Public Life Insurance Co. v. Wheeler*, 477 F.2d 1019 (8th Cir. 1973); *Harbour v. Sheffield*, 269 Ark. 932, 601 S.W.2d 595 (Ark. App. 1980); *York v. McKamy*, 175 Ark. 1170, 300 S.W.2d 317 (1927). A failure to understand the legal effect of language contained in the agreement is not a basis for reformation. *See Clampett v. Ponder*, 91 F. Supp. 533 (W.D. Ark. 1950); *Rector v. Collins*, 46 Ark. 167 (1885). A mutual mistake is one which is reciprocal and common to both parties, each alike laboring under the same misconception in respect to the terms of the written instrument. *Yeargan v. Bank of Montgomery County*, 268 Ark. 752, 595 S.W.2d 704 (Ark. App. 1980).

The instruments executed on July 22, 1985, do not violate the understanding of the parties, both the Lanes and the Panel. There was no mutual mistake. The Court is of the opinion that the instruments accomplished their intended purpose.

The Court has found herein above that there was no fraud or other inequitable conduct on the part of the Panel. Thus, the Lanes' assertion of unilateral mistake fails.

The Lanes contend that because the stock was not "turned back to the company" there exists a mistake of fact. As noted above, it was the Lanes' desire to be shed, in whatever manner, of the duties and responsibilities associated with the direction of the companies. Dorothy

Lane stated after closing the transfer that it was "better that the companies go down with you than with us." For the Lanes to now allege that they would not have executed the stock transfer as drafted had they known that the stock was being placed in trust for the benefit of the employees is at best selfserving.

The Lanes' fourth claim for relief is rescission. The burden is upon the Lanes to establish their right to rescind the stock transfer agreement by clear and convincing evidence. *Centex Construction Co. v. James*, 374 F.2d 921 (8th Cir. 1967); *Baker v. Helms*, 244 Ark. 29, 423 S.W.2d 540 (1968); *Herr v. Murphee*, 240 Ark. 834, 402 S.W.2d 393 (1966).

In the case of *Herrick v. Robinson*, 267 Ark. 576, 595 S.W.2d 637 (1980), the Arkansas Supreme Court held:

> For rescission to be effective it must be timely. One who desires to rescind upon the ground of fraud or deceit must, as soon as he discovers the truth, announce his purpose at once, adhere to it, and act with reasonable diligence, so that all parties may be restored to their original position as nearly as possible; if he continues to treat the property involved in the transaction as his own or conducts himself as though it were still subsisting and binding, he will be held to have waived the objection and will be conclusively bound by the contract as if the fraud had not occurred. *First National Bank v. Coffin*, 184 Ark. 396, 42 S.W.2d 402; *Ratliff v. Bank of New Orleans & Trust Co.*, (1979), 266 Ark – , 586 S.W.2d 237; *McCormick v. Daggett*, 162 Ark. 16, 257 S.W. 358, 13 Am. Jur. 2d 530 (Cancellation of Instruments), §44. Furthermore, as a condition precedent to an effective rescission, the party rescinding must restore, or offer to restore, the opposite part to

his former position. *Davis v. Tarwater*, 15 Ark. 286; *Bellows v. Cheek*, 20 Ark. 424; *Stanford v. Smith*, 163 Ark. 583, 260 S.W. 435. See *also United States v. Arkansas Mill*, 216 F.2d 241 [8th Cir. 1954).

Herrick v. Robinson, 267 Ark. 576, 595 S.W.2d at 643.

In *McCormick v. Daggett, supra*, the Arkansas Supreme Court ruled that "he (the party seeking rescission) is not, says Pomeroy, 'allowed to go on and derive all possible benefits from the transaction, and then claim to be relieved of his own obligation by rescission . . . .' " 586 S.W.2d at 239, citing Pomeroy's Equity Jurisprudence (4th ed.) vol. 2, §897.

The above-cited principles herein applied, the Court finds that the Lanes were less than diligent in their efforts to rescind the stock transfer. Notwithstanding their testimony that they began searching for an attorney soon after executing the documents, there is no corroboration of such effort. Further, the Lanes were advised by the press release on July 22 and by Armbrust and employees the following day, that they had "given away" the companies. The Lanes took no actions, either written or verbal, to dispute the nature of the transfer. The reasons offered for their silence are not persuasive. Therefore, the Court concludes that the claim for rescission is barred. The Lanes chose to challenge their transfer of the ownership only after the rehabilitation of the companies by the Panel and employees.

Furthermore, the Court is of the opinion that, because of the time elapsed between the execution of the stock transfer and other documents and the institution of this action, it would be impossible to restore the parties

to their original position. The Lanes were paid their consulting fees as provided by the agreement. The Panel sold first the North Carolina operation for a profit after satisfaction of the heavy debt laid on that division by the Lanes. The Panel made the operations profitable. The Panel was successful in negotiating an arrangement with the creditors on Alabama and Arkansas divisions to accept a reduction in their claims. Then, these two divisions were made marketable, resulting in the Tyson sale. The Lane companies are near discharge by the Bankruptcy Court in North Carolina, with only a few unsecured claims remaining to be paid. Mr. Peterson stated that he, as examiner, was required to make a final report to the Bankruptcy Court. All of this transpired without any effort by or assistance from the Lanes. To allow them to reclaim the companies they abandoned at the brink of collapse by reforming the stock transfer agreement or by rescinding the agreement would be unconscionable. Of course, had the companies not sold for a profit, this action would never have been commenced.

Without the efforts of the Panel (and the employees), the companies would have been forced into liquidation. By early takeover on July 22, the panel was able to extend the cure periods some 30 days under the Plan. Also, the Panel negotiated with creditors for forbearance on the payments while they implemented the changes necessary to pull the companies from the depths of their financial dilemma.

Even if the rescission claim had been timely made, the Court is of the opinion that the Lanes have failed to sustain their burden of proof. (See discussion of the

Lanes' claim for reformation above (finding no mutual mistake, unilateral mistake or fraud, deceit or inequitable conduct on the part of the Panel members)). The Lanes received precisely that for which they bargained, their release from the company and, in the course of events, the preservation of their personal assets by avoidance of liquidation and foreclosure on the personal guaranties. They also were provided a means of support in the consultancy contract. Valuable consideration was given by the Panel.

The Court is of the opinion that the stock transfer agreement and the related documents executed on July 22, 1985 are unambiguous. Further, the Court finds no credible evidence that the transactions, taken as a whole and separately, are unconscionable. An unconscionable contract is one which "no man in his senses and not under delusion would make on one hand, and . . . no honest and fair man would accept on the other. . . ." *Hume v. United States*, 132 U.S. 406, 411 (1889); *Geldermann & Co. v. Lane Processing Co., supra.* The Court has herein made the specific findings of fact concerning the circumstances surrounding the negotiation and execution of the instruments. The Court finds no gross inequality of bargaining power and that the Lanes were aware of and comprehended the import of their actions.

The Lanes make a plea for reformation of the trust instrument executed by the Panel, as Trustees, on July 22, 1985. The Court inquired at the close of the testimony in this case whether the parties could strike an accord on the designation of beneficiaries, possibly including the Lanes as beneficiaries under the Declaration of Trust. The trust instrument provides that "the Trustees may amend this

Declaration, so long as the provisions of Sections 4 and 5 are not amended." This power has been exercised on two occasions, more clearly delineating the beneficiaries. However, such a compromise has evidently been unacceptable by the parties.

The Court is of the opinion that the Lanes are not parties to the Declaration of Trust, thus, they have no right to reformation of that instrument.

Therefore, the Court concludes that the plaintiffs, Dorothy P. Lane and Clift C. Lanes, individually and as Trustees, have failed to sustain their burden of proof on each count of their complaint. The Court concludes that the complaint should be dismissed with prejudice and Judgment entered for the defendants. A separate Judgment shall be entered contemporaneously herewith.

Dated this 2nd day of July, 1987.

Oren Harris
UNITED STATES DISTRICT JUDGE

U.S. DISTRICT COURT
WESTERN DIST. ARKANSAS
F I L E D
July 02, 1987
BEVERLY R. STITES, Clerk
By Deputy Clerk

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